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### Mutually Assured Protection Among Large U.S. Law Firms

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# MUTUALLY ASSURED PROTECTION AMONG LARGE U.S. LAW FIRMS

TOM BAKER AND RICK SWEDLOFF<sup>‡</sup>

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*Top law firms are notoriously competitive, fighting for prime clients and matters. But some of the most elite firms are also deeply cooperative, willingly sharing key details about their finances and strategy with their rivals. More surprisingly, they pay handsomely to do so. Nearly half of the AmLaw 100 and 200 belong to mutual insurance organizations that require member firms to provide capital; partner time; and important information about their governance, balance sheets, risk management, strategic plans, and malpractice liability. To answer why these firms do so when there are commercial insurers willing to provide coverage with fewer burdens, we talked to dozens of people in large law firms and the insurance industry, including those at the notoriously secretive mutual insurers. We developed a unique, qualitative data set that sheds important, new light on the legal industry, insurance markets, and the mutual insurers that protect many large law firms from malpractice risks.*

*We show that many of the most elite firms prefer the mutuals, in part, because they help solve traditional insurance market failures like adverse selection, moral hazard, and long-term contracting. But this only tells part of the story. We also provide an important and novel autonomy explanation. Many lawyers prefer mutual insurance because they perceive that it promotes professional independence in the face of the social control imposed by liability and insurance.*

*Our data also reframes the traditional understanding of organizational forms in the commercial insurance market. Most prior literature describes mutual and stock insurers as competitors. We show that stock and mutual insurers play complementary and symbiotic roles. Mutuals*

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*help manage access to the powerful risk-distributing potential of stock insurance through reinsurance and excess coverage, thus creating mutual-stock hybrids. Further, we provide evidence that suggest that even outside of this relationship, mutuals favorably affect the behavior of stock insurers, indicating that these mutual arrangements produce positive externalities that benefit other lawyers and law firms in similar practice contexts.*

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## I. INTRODUCTION

The top law firms in the nation are fierce competitors. High-paying clients and high-profile matters are a scarce and precious resource in the quest for prestige and ever-greater per-partner-profits. They are the key to the financial health of firms and the wealth of individual partners. Thus, it is only natural that firms regularly compete for matters and clients.

This should not be a surprising or contentious claim. What is surprising is that, despite this fierce competition, a large number of the elite firms in the nation are members of mutual insurance organizations. These organizations allow partners from each of the members to learn intimate details about each other, including their governance structures, financial health, risk management, strategic growth plans, and potential malpractice liability.<sup>1</sup> Further, these mutual insurers require firms to devote significant senior partner time and money to participate in the making of their liability insurance. Firms that belong to mutual professional liability organizations contribute capital to, and have professionals that work on committees for, and attend meetings of their mutuals, despite the availability of commercial malpractice insurance that does not require law firms to make the same kind of commitments.

The extent of this mutual insurance presents a second puzzle. In contrast to commercial or stock insurers, which can access all the forms of capital available in the market, mutual insurers are owned wholly by their policyholders.<sup>2</sup> As a result, mutual insurers cannot, on their own, distribute the risk of loss beyond their members, which should be a comparative

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<sup>1</sup> See *infra* Part I.

<sup>2</sup> We take a functional approach to what constitutes a “mutual” insurer, not an insurance regulatory approach, with the result that, for us, member-owned captive insurance companies, member-operated risk retention groups, and even member-operated risk purchasing groups all qualify as mutual insurers, subject to differences that we will highlight as appropriate.

disadvantage in the market.<sup>3</sup> Because of their greater access to capital, stock insurers should be able to more fully and cheaply distribute risk and thus out-compete mutuals. Yet, mutual insurers not only continue to exist; they are thriving. In very rough terms, lawyers-only mutual insurers cover the malpractice risks of more than 40% of all lawyers practicing in firms in the United States with over 50 lawyers.<sup>4</sup> The law firms that belong to these mutual insurers are an elite group, including about half of the 100 and 200 most profitable law firms in the U.S.<sup>5</sup>

In this Article we use qualitative empirical research methods to better understand the comparative advantages of mutual insurers. In doing so we make five main contributions.

First, we provide previously unpublished detail on the mutual insurance organizations operating in the medium- to large-firm lawyers' professional liability (LPL) market. These organizations are notoriously protective of their operations. Outside of a small group of LPL insurance brokers and reinsurers, and, perhaps, a few lawyers, no one else has the detailed information that we have collected. Further, the organizational details that are available in the public domain have never been the subject of the kind of comparative analysis we provide here, shedding new light on the risk management of many large law firms in this country.<sup>6</sup>

Second, we critically evaluate and find evidence consistent with the prevailing "market failure" explanations offered for the presence of mutual

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<sup>3</sup> Of course they can and do purchase reinsurance and, in theory, they could issue debt, but stock insurers can do so as well; and stock insurers can also sell equity.

<sup>4</sup> See *infra* note 19 for how we made this calculation.

<sup>5</sup> We determined the number of mutual insurers' members in the AmLaw 100 and the AmLaw 200 by adding up the number of ALAS, BAR, MPC, and AIM members in the AmLaw 100 and the AmLaw 200, respectively. *Compare* Growth Falls Slightly, AM. L., Jun. 1, 2015, at 83, and A Healthy Gain, AM. L., May 1, 2015, at 146, with ATTORNEYS' LIAB. ASSURANCE SOC'Y LTD., 2013 ANNUAL REP. 23 (2014) [hereinafter ALAS 2013 REP.], ATTORNEYS' LIAB. ASSURANCE SOC'Y LTD., 2014 ANNUAL REP. 79–83 (2015) [hereinafter ALAS 2014 REP.], and List of BAR Members (confidential and incomplete list, on file with authors); List of MPC Members (confidential and incomplete list, on file with authors); List of AIM Members (confidential and incomplete list, on file with authors).

<sup>6</sup> See also Rick Swedloff & Tom Baker, *Insurers as Bumblebees in the Garden of Law Firm Norms* (working paper 2016).

insurers in other contexts: adverse selection, moral hazard, and long-term contracting problems.<sup>7</sup>

Third, we present evidence of a previously unexplored autonomy explanation for the success of mutual insurers. We find the desire for professional independence to lie at the core of several of the most common reasons that the participants in the mutuals gave to us for preferring mutual insurance arrangements: long-term, stable insurance relationships; a peer-reviewed claims experience; and peer-based loss prevention.<sup>8</sup> Many lawyers, and presumably doctors and other professionals, perceive that mutual insurance arrangements help them retain greater professional independence in the face of the social control that may be imposed by liability and liability

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<sup>7</sup> See Richard MacMinn & Yayuan Ren, *Mutual versus Stock Insurers: A Synthesis of the Theoretical and Empirical Research*, 34 J. INS. ISSUES 101 (2011) (identifying agency problems, in particular, moral hazard and adverse selection, as causes for mutualization); Henry Hansmann, *The Organization of Insurance Companies :Mutual versus Stock*, 1 J. L., ECON., & ORG. 125 (1985) [hereinafter Hansmann, *The Organization of Insurance Companies*] (suggesting that mutuals arose in the life insurance market to solve problems of long-term contracting under uncertainty and that mutuals arose in the property and liability insurance markets to solve adverse selection problems, to efficiently share aggregate industry risk, and to mitigate the impact of rate regulation). See also HENRY HANSMANN, *THE OWNERSHIP OF ENTERPRISE* 277 (Harvard University Press 1996) [hereinafter Hansmann, *THE OWNERSHIP OF ENTERPRISE*] (“[M]utual companies evidently arise in part because insurance companies cannot easily distinguish between prospective insureds that differ in the risks they represent.”); James A. Ligon & Paul D. Thistle, *The Formation of Mutual Insurers in Markets with Adverse Selection*, 78 J. BUS. 529, 534 (2005) (suggesting adverse selection as a major incentive for the formation of mutual insurance); David Mayers & Clifford W. Smith, Jr., *Ownership Structure Across Lines of Property Casualty Insurance*, 31 J. L. & ECON. 351, 356-57 (1988) (arguing that the major benefits of mutuals rest on their limitations on ownership rights and the degree to which policyholders control mutuals).

<sup>8</sup> See *infra* Part II.

insurance.<sup>9</sup> This explanation dovetails with prior work describing autonomy and independence as animating principles of the legal profession.<sup>10</sup>

Fourth, our findings significantly reframe the scholarly understanding of the relationship among organizational forms in the commercial liability insurance market. Corporate law and insurance literature typically views mutual and stock insurers as competitors, not complements.<sup>11</sup> We show that, while there is spirited competition between

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<sup>9</sup> GEOFFREY C. HAZARD JR. & ANGELO DONDI, *LEGAL ETHICS: A COMPARATIVE STUDY* 146 (2014) (“A second norm of professional ethics, which for many lawyers would be the first principle, is independence.”).

<sup>10</sup> *E.g.*, *id.* at 146-47 (recognizing professional independence as one norm of lawyers’ professional ethics); RICHARD L. ABEL, *AMERICAN LAWYERS* 35 (1989) (“An essential foundation of structural functional theories of the professions is the belief that, if protected from outside interference, they will use their expertise for the general good.”); Susan P. Koniak, *Law between the Bar and the State*, 70 N.C. L. REV. 1389, 1450 (1992) (identifying *nomie* autonomy as one aspect of the bar’s *nomos*).

<sup>11</sup> *See, e.g.*, Thomas R. Berry-Stölzle et al., *Determinants of Corporate Diversification: Evidence from the Property-Liability Insurance Industry*, 79 J. RISK & INS. 381 (2012) (discussing separately the variations in line-of-business diversification status and the difference between mutual insurers and stock insurers); Cassandra R. Cole et al., *Separation of Ownership and Management: Implications for Risk-Taking Behavior*, 14 RISK MGMT. & INS. REV. 49 (2011) (examining how the separation of ownership from management influences the risk-taking behavior of mutual and stock ownership insurers); Bruce D. Smith & Michael Stutzer, *A Theory of Mutual Formation and Moral Hazard with Evidence from the History of the Insurance Industry*, 8 REV. FIN. STUD. 545, 546 (1995) (discussing how mutuals and stock insurance deal with moral hazard differently); Joan Lamm-Tennant & Laura T. Starks, *Stock Versus Mutual Ownership Structures: The Risk Implications*, 66 J. BUS. 29 (1993) (discussing empirical tests of the risk differences between stock and mutual insurers in the property-liability insurance industry); Mark R. Greene & Richard E. Johnson, *Stocks vs Mutuals: Who Controls?*, 47 J. RISK & INS. 165 (1980) (discussing the differences in the patterns of legal control by the legal owners of stock and mutual insurers). One exception is Ligon & Thistle, *supra* note 7 (developing a model in which mutual and stock companies co-exist in a separating equilibrium in which high risk insureds prefer the more complete insurance provided by stock insurance companies).

stock and mutual insurers and some ebb and flow in the relative market shares of the different kinds of organizations, the different organizational forms play complementary roles.<sup>12</sup> For example, the mutual insurers all purchase reinsurance from stock insurers (or from syndicates in the London market that have access to the same or similar equity markets as stock insurers), and most of the mutuals also arrange their members' purchase of insurance from these commercial insurers for higher-level excess layers of protection.<sup>13</sup> Thus, the choice in the LPL insurance market is not between purely stock and purely mutual insurance, but rather between stock and mutual/stock hybrids, with the degree of mutualization differing among the hybrids that presently exist.

Finally, and perhaps most importantly, we provide a basis for concluding that lawyers' participation in their mutual insurance organizations provides benefits for other lawyers and law firms engaged in similar kinds of legal practice. Just as the mutuals hybridized to provide the risk spreading offered by commercial insurers, so too have the commercial insurers adapted to compete with the mutuals. With the assistance of insurance brokers and other third-party service providers, the commercial insurers claim that they are now able to offer similar loss prevention services, similar quality claims services, and similarly stable, long-term relationships. Further we find that commercial insurers do so because they must to compete with the mutuals. Whether they would continue to do so in the absence of the mutuals is, of course, impossible to know. And given the commitment of many law firms to their mutuals it is unlikely that we will find out anytime soon.

This article proceeds as follows. After describing our research methods in Part I, we introduce in Part II the forms of mutual insurance presently operating in the medium to large LPL market. The largest mutual LPL insurer is the Attorneys Liability Assurance Society, commonly referred to as ALAS. There are three smaller mutuals that, to a significant degree, owe their existence to an early decision by ALAS to exclude Wall Street firms and to discourage California firms from joining. In addition, there is a risk purchasing group for mid-sized law firms that could serve as an easier-to-implement model for other firms. While there are important differences among these organizations, they are all owned by their law firm members and they all engage in a variety of loss prevention, claims management, and other member service activities that assume that the members have joined the mutual for the long run.

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<sup>12</sup> See *infra* Part III.

<sup>13</sup> *Id.*

In Part III, we report what we learned from our qualitative research about the demand for mutual insurance. There are three aspects of the prevailing market failure explanations for the comparative advantages of mutual insurers that appear to fit reasonably well within the context of the LPL market. The first two are the well-known and deeply-researched information problems of adverse selection and moral hazard. The third is a long-term contracting problem that, previously, has been used in the insurance literature primarily to explain the success of the mutual form in the life insurance market.<sup>14</sup>

We then introduce and explore a complementary, professional independence explanation for the success of mutual insurance arrangements in the LPL market. This explanation is complementary to the market failure explanation because insurers' classic response to these market failures is various forms of social control – "insurance as governance" or "insurance as regulation" – that law firms easily could experience as a threat to professional autonomy.<sup>15</sup> These insurance as governance aspects of the

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<sup>14</sup> See generally Hansmann, *The Organization of Insurance Companies*, *supra* note 7 (explaining the uncertainties of long-term contracting for life insurance).

<sup>15</sup> See Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237, 280-82 (1996) [hereinafter Baker, *On the Genealogy of Moral Hazard*] (arguing that insurance is often conditioned on both the care to prevent a loss and insurers' controls over insureds' ability to recover loss); Tom Baker & Rick Swedloff, *Regulation by Liability Insurance: From Auto to Lawyers Professional Liability*, 60 UCLA L. REV. 1412, 1418-23 (2013) (noting that insurance contract design, claims management, loss prevention services, are among the most important tools that insurers use to regulate their insureds). See generally RICHARD V. ERICSON ET AL., *INSURANCE AS GOVERNANCE* (2003) (developing the concept of insurance as a form of governance beyond the state and providing examples from a variety of fields); Kenneth S. Abraham, *Four Conceptions of Insurance*, 161 U. PA. L. REV. 653, 657 (2013) ("Finally, the *governance conception* views insurance as a surrogate for government in controlling behavior and protecting against misfortune, as well as an organizational arrangement among policyholders. These governance relationships create the risk of abuse by the insurer for its own ends, and for the ends of the majority of policyholders at the expense of the minority"); Omri Ben-Shahar & Kyle D. Logue, *Outsourcing Regulation: How Insurance Reduces Moral Hazard*, 111 MICH. L. REV. 197 (2012) (providing examples of



insurance relationship are more readily seen as furthering lawyers' professional independence when the entity filling the insurance function is a mutual insurer composed of and directed by fellow law firms, not an outside entity seeking profits at law firms' expense. In the words of one of the law firm general counsels we interviewed, "You could say [mutual insurer] – which has its own officers and directors – pushes things to us, but **we** own it, and **we** direct it to do so."<sup>16</sup>

In Part IV we first describe and assess contradictory reports from suppliers and purchasers of the commercial LPL insurance provided by large, publicly traded insurance companies, who assert that this more commercial form of LPL insurance can meet the needs of medium to large law firms just as well as the mutual insurance arrangements, often at lower cost. We then examine more closely the financial relationships between the LPL mutual insurers and the commercial insurance market. We find that all the mutual LPL insurers purchase reinsurance and all of them, except ALAS, go to the commercial market to obtain excess insurance for their members. Moreover, the commercial insurance market has adapted to provide benefits that commercial insurers did not provide when the mutuals were formed. Thus, the LPL insurance choice that law firms face is not between purely mutual and purely commercial insurance arrangements but rather between mutual/commercial hybrids and commercial insurers that have consciously adapted to compete with the hybrids.

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private insurance serving a regulatory function). For recent accounts of insurance as governance in the context of corporate compliance and municipal police departments, see Shaubin Talesh, *Legal Intermediaries: How Insurance Companies Construct the Meaning of Compliance with Anti-Discrimination Laws*, 37 L. & POL'Y 209 (2015); John Rappaport, *How Private Insurers Regulate Public Police*, 130 HARV. L. REV. 1539 (2017).

<sup>16</sup> See Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #26, at 6 (Jul. 12, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #26]. Much of the evidentiary base for our research comes from a series of over 50 semi-structured interviews with participants in the medium to large law firm LPL market and from participant observations in law firm and insurance settings. Our interviews were confidential. When we quote our respondents, we identify them only by number and, where appropriate, by title. We identify details of the operation of specific organizations only as necessary and, with regard to information that we understand to be sensitive, only if we were able to obtain that information from public sources or from respondents who were not closely connected to that organization.

We conclude that the LPL mutual advocates and their critics are, to a substantial degree, both right. From a risk spreading perspective, there is less difference than the LPL mutual advocates suggest. On the other hand, there do appear to be real differences in the approach and commitment to loss prevention among mutual and commercial insurers, and the mutuals do appear to offer law firms a qualitatively different claims handling experience. But LPL brokers are working hard to reduce that gap, both to entice the occasional mutual member to leave the fold and to discourage existing customers from joining the fold.

As this latter point illustrates, to the extent that mutual insurance arrangements in fact promote professional independence, they do so both directly and indirectly. Mutual insurers promote professional independence directly by granting their member law firms significant control over risk distribution and management, and they promote professional independence indirectly by serving as a model that the brokers and stock insurance arrangements emulate. Accordingly, our research provides reasons for lawyers and the organized bar to promote mutual insurers even if most law firms are likely to continue to purchase all their LPL insurance from the commercial market.

## II. RESEARCH METHODS

This Article is based on qualitative research into lawyers' liability and insurance, consisting of in-depth, semi-structured interviews and participant observation in LPL insurance programs. We interviewed professionals involved in pricing and selling LPL insurance (brokers, underwriters, actuaries, and senior executives in insurance companies); lawyers involved in buying and managing LPL insurance (general counsels, insurance partners, and risk managers); professionals who provide risk management services as part of LPL insurance arrangements (employed by brokers, insurers, and law firms); and, to a lesser extent, professionals involved in the LPL insurance claims process (both lawyers and insurance company personnel).

The interviews were semi-structured, meaning that we followed an organized research protocol, but we allowed the interviews to unfold variably based on the expertise and interests of the respondents. Interviews typically lasted between thirty minutes and one hour, and we often followed up to ask clarifying questions as the research progressed. We recorded and transcribed the interviews and coded them by themes and topics using Nvivo coding software. Each principal investigator conducted about half of the interviews; each read the transcripts of the other almost immediately after

each interview; and we discussed our impressions and interview techniques continuously through the research period before beginning coding. We interviewed a total of 53 respondents in the following categories: actuaries (2); brokers (9); loss prevention specialists (4); C-suite insurance company executives (5); insurance and reinsurance underwriters (8); law firm general counsels or associate general counsels (16); law firm insurance partners (4); monitoring counsel (4); and claims professionals (4). The subcategories total more than 53 because some respondents have held more than one of these positions in their careers.

We identified our prospective interviewees from leaders in the LPL insurance market. We then expanded outward to references from the initial interviewees. This snowball method has obvious limitations: it does not produce a random sample; it cannot include people who are unwilling to be interviewed; and, because we learn a great deal over the course of the research, our early interviews differ significantly from our later interviews. With that said, we are confident that what we have learned represents an objective, valid, and shared understanding of the LPL insurance market. The LPL market is reasonably concentrated, especially among insurers for large law firms. There are a limited number of insurers, reinsurers, and brokers active in the market. We have interviewed or otherwise interacted with people who worked in most of the leading insurance organizations during the period of the research. We interviewed lawyers in a cross section of the medium to large firm market that was weighted to the AmLaw 200. Finally, we sent preliminary drafts of this article to a cross section of our respondents, offering them the opportunity to correct any mistakes or misimpressions.

### III. MUTUAL INSURANCE ORGANIZATIONS IN THE LPL MARKET

For law firms in the United States that have more than 35 lawyers, there are three alternatives to purchasing a primary insurance policy directly from commercial insurers (i.e. stock insurers and Lloyd's of London syndicates):<sup>17</sup> (1) a relatively large, national mutual insurance company that

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<sup>17</sup> Except for Liberty Mutual, the large, general-purpose mutual property casualty companies do not provide LPL insurance. Liberty Mutual's participation is reportedly indistinguishable from its stock insurer competitors. *See* Tom Baker & Rick Swedloff, Email from Respondent #5 (July 5, 2016) (on file with author). Separate treatment of the stock insurance companies and the Lloyd's syndicates awaits future work.

is the largest insurer of such law firms in the U.S.; (2) three smaller and more geographically focused mutual insurance arrangements; and (3) a risk purchasing group for mid-sized law firms. Not all law firms have these mutual insurance options, and not all law firms that have these options use them, but altogether these organizations provide insurance for over 80,000 lawyers including about half of the AmLaw 100 and 200, and a sizeable number of smaller, high-quality boutique and regional law firms.<sup>18</sup> Extrapolating from the available lawyer demographics, these 80,000 lawyers comprise over one-third of all lawyers working in firms larger than twenty lawyers and about forty percent of all lawyers working in firms larger than fifty lawyers, as very rough approximations.<sup>19</sup>

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Historically, Lloyd's syndicates were owned by their managers, who obtained the necessary capital from individuals who were completely passive, as distinguished from stock insurance companies, which were owned by the individuals who provided the capital, i.e. the shareholders. Today, we suspect that institutional investors own most of the shares in the stock insurance companies and also supply most of the capital to Lloyds, indirectly through their ownership of the shares of the companies that directly provide capital to Lloyds. Lloyd's became predominantly corporate in the years following the Reconstruction and Renewal process of the early 1990s.

<sup>18</sup> *Supra* note 5.

<sup>19</sup> The most recent year for which there are data that break down private law practice by size of firm is 2005. Of the lawyers in private practice, about half worked as solo practitioners in 2005, 16% worked in firms of 100 lawyers or more, and 10% worked in firms of 21-100 lawyers. CLARA N. CARSON & JEEYOUN PARK, THE LAWYER STATISTICAL REPORT: THE U.S. LEGAL PROFESSION IN 2005, at 5-6. As of 2005, there were 111,523 lawyers in firms with more than 100 lawyers, 26,467 lawyers in firms with 51-100 lawyers, and 41,833 lawyers in firms with 21-50 lawyers. *Id.* The ABA reports that the total population of lawyers grew by 15% in the 2005 to 2015 period. *2015 National Lawyer Population Survey: Historical Trend in Total National Lawyer Population 1878-2015*, A.B.A., [http://www.americanbar.org/content/dam/aba/administrative/market\\_research/total-national-lawyer-population-1878-2015.authcheckdam.pdf](http://www.americanbar.org/content/dam/aba/administrative/market_research/total-national-lawyer-population-1878-2015.authcheckdam.pdf) (last visited June 3, 2016). Because ALAS, AIM, and PilotLegis includes some law firms with fewer than 50 lawyers, the one third and one-half shares referred to in the text should be taken as rough approximations. Moreover, American Bar Foundation reports that the trend has been for a larger share of lawyers to

While these insurers are not formally organized as mutual insurers for insurance regulatory purposes, in each case the members are both policyholders and owners, and there are no shareholders or other outside investors with an ownership interest. Three of the four are group “captive” insurers, and the fourth is a “risk retention group.”<sup>20</sup> The differences between these forms of organization and that of mutual insurance companies like State Farm or Liberty Mutual relate primarily to capital requirements and other aspects of state regulatory supervision, not to things that make an organization a “mutual” for economic purposes. As a practical matter, the regulatory differences mean that the LPL mutuals are even more truly mutual organizations, because the lower regulatory scrutiny of group captives and risk retention groups requires greater self-regulation by members.

The sections that follow describe each of these mutual insurers. Readers who are focused primarily on how our investigation of the LPL market advances the law and economics understanding of liability insurance might wish to skim, or even skip over, this section. Of course, for readers who are interested primarily in the LPL market, this is the most important section of this Article. Much of what we report here has never been

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work in larger firms, so the 15% growth rate is unlikely to be constant across the size of firms. *Id.*

<sup>20</sup> ALAS 2013 REP., *supra* note 5, at 9. The concept of a “captive” insurer began as a mechanism for large corporations to adapt the insurance form to what is functionally a self-insurance program, with minimal regulatory oversight. There then developed multi-member captives, which, for present purposes, can be understood as lightly regulated, non-transparent mutual insurance companies. *Advantages of Captive Insurance*, VT. DEP’T OF FIN. REG., <http://www.dfr.vermont.gov/captives/advantages-captive-insurance> (last visited June 5, 2016) (listing the advantages of Vermont domestic captive insurance). The International Risk Management Institute defines a risk retention group as follows:

An insurance company formed pursuant to the federal Risk Retention Act of 1981, which was amended in 1986 to allow insurers underwriting all types of liability risks except workers compensation to avoid cumbersome multistate licensing laws. An RRG must be owned by its insureds.

IRMI Glossary <https://www.irmi.com/online/insurance-glossary/terms/r/risk-retention-group-rrg.aspx> (last visited November 16, 2017).

published, and none of it in this consolidated, comparative form. Some additional detail about the LPL mutuals appears in Part III.D.

A. THE BIG LAWYERS' MUTUAL: ALAS

ALAS is short for the Attorneys' Liability Assurance Society, the largest, best-known, and most public mutual insurer in the LPL market. ALAS was formed by about 30 large U.S. law firms in 1979,<sup>21</sup> in the wake of the mid-1970's availability crisis in the U.S. liability insurance market.<sup>22</sup> Donald Breakstone, a former ALAS general counsel and former partner in a large Chicago law firm who helped to create ALAS, described the origins of ALAS and the central goals and beliefs of ALAS members as follows:

ALAS's core purpose for existing, and the need that brought its member firms together in 1979, was to provide stable and high quality professional liability coverage to its large law firm members. What drew the initial 31 member law firms together were several commonly held goals and beliefs, namely that:

- Commercial insurers providing professional liability coverage to large law firms were unstable and inconsistent providers - insurers could and did enter and leave that market at will, making it difficult, if not impossible, for large law firms to count on the continual availability of needed coverage;
- Large law firms were not rated by commercial insurers as an independent risk class - instead large law firms were lumped together with individual lawyers, small law firms, individual

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<sup>21</sup> *About the ALAS Companies*, ATTORNEYS' LIAB. ASSURANCE SOC'Y LTD., <http://www.alas.com/public/about.aspx> (last visited June 7, 2016) (reporting that the initial number of firms was 35, which is inconsistent with the number – 31 – given in the Breakstone article, *infra* note 23).

<sup>22</sup> See Tom Baker, *Medical Malpractice and the Insurance Underwriting Cycle*, 54 DEPAUL L. REV. 393 *passim* (2005) [hereinafter Baker, *Underwriting Cycle*] (noting that the mid-1970s and the mid-1980s were hard market years for liability insurance); Tom Baker, *The Shifting Terrain of Risk and Uncertainty on the Liability Insurance Field*, 60 DEPAUL L. REV. 525-526 (2011) [hereinafter Baker, *The Shifting Terrain of Risk and Uncertainty*] (showing that the two liability insurance crises occurred in the mid-1970s and mid-1980s respectively).

accountants, small accounting firms, and the then Big 8 accounting firms in assessing risks and establishing "proper" premiums; and

- Large law firms, bound together in their own mutual facility, were in a much better position than commercial insurers to understand and meet the professional liability needs of their own profession through a broad policy form, fair claims management, and a state of the art loss prevention program.<sup>23</sup>

As of January 1, 2017, ALAS had grown to 213 member firms, with 60,507 practicing attorneys.<sup>24</sup> ALAS describes its membership philosophy as one of "preferred risk underwriting."<sup>25</sup> Membership is limited to high quality firms of at least 35 lawyers (many significantly larger) with an acceptable "management structure, claims history, and approach to loss prevention."<sup>26</sup> The law firms that are ALAS members tend to have an elite reputation. ALAS members include 77 of the AmLaw 200, 28 of the AmLaw 100,<sup>27</sup> and 6 of the 22 firms with more than 1000 lawyers, with a conspicuous under-representation of California and New York City law firms that is the result of underwriting decisions made in the early years of ALAS' existence.<sup>28</sup>

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<sup>23</sup> Donald Breakstone, *What Makes for Successful Risk Retention Groups: A Veteran of America's Largest RRG Shares His Experience*, 19 RISK RETENTION REP. (2005).

<sup>24</sup> ATTORNEYS' LIAB. ASSURANCE SOC'Y LTD., 2017 ANNUAL REP. 11 (2017) [hereinafter ALAS 2016 REP.].

<sup>25</sup> ALAS 2016 REP., *supra* note 5, at 21 (noting that ALAS has remained committed to applying its "preferred risk underwriting" standards in a uniform manner).

<sup>26</sup> In correspondence, Hebert Kritzer reports that, as part of his research for work in progress, he has compiled the number of lawyers in ALAS firms and that there are 5 firms in ALAS with fewer than 35 lawyers, the smallest with 16 lawyers, possibly as a result of firms having joined ALAS before ALAS established the rule that member firms must have at least 35 lawyers. ALAS 2014 REP. *supra* note 5, at 22 ("We continue to maintain a selective approach to new firm recruiting. . . . We review a firm's application with particular focus on the applicant's management structure, claims history, and approach to loss prevention.").

<sup>27</sup> *Supra* note 5.

<sup>28</sup> See Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #12, at 4 (Dec. 19, 2013) (unpublished interviews, on file with

ALAS is governed through a committee structure staffed by partners of the member firms. These committees oversee core functions such as claims, underwriting and member services, loss prevention, investments, and reinsurance. ALAS has an active loss prevention program. The program is traditionally run by former partners from member firms in “communication and interaction with” a partner in each member firm that is designated as a “Loss Prevention Partner.”<sup>29</sup> The Loss Prevention Partner in each firm serves as a conduit to the rest of the firm about loss prevention best practices. ALAS also has an active claims management program; it has the right to approve members’ selection of claims counsel, and it participates actively in the management of claims.<sup>30</sup>

In addition to its size, there are several characteristics that distinguish ALAS from the three small mutuals that we describe next. First, ALAS has a significant permanent staff, the senior members of which have traditionally been drawn from member law firms, with a large percentage of lawyers involved in claims management, loss prevention, underwriting, and general management.<sup>31</sup> Second, ALAS engages in “unitary pricing,” meaning that all member firms are charged the same per lawyer price for a given combination of “self-insured retention” (similar to a deductible) and limit of coverage. Because of differences in firm size, retentions and limits,

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authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #12] (“When ALAS was founded—the owners of the company—there was a bylaw provision that prohibited the admission of New York-based firms.”); *See also* ATTORNEYS’ LIAB. ASSURANCE SOC’Y LTD., 2000 ANNUAL REP. 6 (2001) (noting that ALAS bylaws were changed that year to remove geographic restrictions that had previously existed).

<sup>29</sup> ATTORNEYS’ LIAB. ASSURANCE SOC’Y LTD., 2001 ANNUAL REP. 21 (2002) (“[T]he ALAS loss prevention program is a cooperative endeavor that involves Loss Prevention Counsels in regular communication and interaction with the designated Loss Prevention Partners in each Member Firm.”); *Loss Prevention*, ATTORNEYS’ LIAB. ASSURANCE SOC’Y LTD., [http://www.alas.com/public/about\\_lp.aspx](http://www.alas.com/public/about_lp.aspx) (last visited June 7, 2016) (“ALAS loss prevention counsel, all former partners at established, high-quality firms, provide a wide range of services to meet this need.”).

<sup>30</sup> *See id.*

<sup>31</sup> *ALAS, Inc. Personnel*, ATTORNEYS’ LIAB. ASSURANCE SOC’Y LTD., [http://www.alas.com/public/personnel\\_inc.aspx](http://www.alas.com/public/personnel_inc.aspx) (last visited June 7, 2016); *A Legal Mindset Permeates ALAS*, 22 RISK RETENTION REP. 4 (2008).



member firms pay different total premiums, however. Third, ALAS issues insurance policies directly to its members with limits up to \$75 million (increased to \$100 million in 2017), which is an extraordinarily high level of insurance coverage from a single source in the liability insurance market as a whole, not just LPL insurance. This means that many ALAS members do not need to buy any additional excess LPL insurance from the commercial market. Finally, ALAS does not arrange for the purchase of higher levels of excess coverage by its members, which means that the largest law firm members of ALAS must use commercial insurance brokers to arrange their excess insurance each year, giving them regular, direct exposure to the commercial market.

#### B. THE SMALL LAWYERS' MUTUALS

To a significant degree, the three smaller mutual LPL insurance organizations owe their existence to underwriting decisions made by ALAS in the early years. At inception ALAS members elected to exclude New York City firms and to discourage the participation of California firms, among other ways by charging California firms higher premiums.<sup>32</sup> A senior LPL broker explained to us that this ALAS policy was the result of an underwriting policy of ALAS's most important reinsurer.<sup>33</sup> This meant that firms in New York City and California that wanted access to mutual insurance had to create their own mutual insurers. The three mutuals we describe here – BAR, MPC and AIM – were the result.

These three small mutual insurers are even more protective of their organizational details and practices than ALAS. They do not release annual reports and, as a rule, neither the organizations nor their members make public statements about their operations. Ours is the most detailed public report of their organization and practices, and we learned many additional

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<sup>32</sup> See ATTORNEYS' LIAB. ASSURANCE SOC'Y LTD., 1987 ANNUAL REP. 13 (1988) (showing differential rates for California member firms on a per attorney basis); See also LPL Ins. Interviews, Interview with Respondent #12, *supra* note 28, at 4 ("When ALAS was founded—the owners of the company—there was a bylaw provision that prohibited the admission of New York-based firms.").

<sup>33</sup> Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #6, at 2, 13 (Dec. 6, 2013) (unpublished interviews, on file with authors).

details that we cannot describe publicly in order to protect the confidentiality of our sources.

The oldest of the three, Bar Assurance and Reinsurance Limited (“BAR”) was organized in 1979 by 21 New York City firms.<sup>34</sup> Bar now has just under 20 member firms, all still based in New York City, with about 12,000 practicing lawyers.<sup>35</sup> The second smaller mutual, MPC, was organized in the early 1980s by San Francisco firms. Originally known as the “Managing Partners Council,”<sup>36</sup> MPC now has 9 member firms, with more than 7000 practicing lawyers.<sup>37</sup> While the center of gravity remains San Francisco, MPC members include at least two large firms that are based

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<sup>34</sup> The National Law Journal reported in 1992 that the following firms were members: (1) Cadwalader, Wickersham & Taft; (2) Chadbourne & Parke; (3) Cleary, Gottlieb, Steen & Hamilton; (4) Cravath, Swaine & Moore; (5) Davis Polk & Wardwell; (6) Debevoise & Plimpton; (7) Dewey Ballantine; (8) Donovan Leisure Newton & Irvine; (9) Fried, Frank, Harris, Shriver & Jacobson; (10) Kaye, Scholer, Fierman, Hays & Handler; (11) Lord Day & Lord, Barrett Smith (12) Milbank, Tweed, Hadley & McCloy; (13) Mudge Rose Guthrie Alexander & Ferdon; (14) Paul, Weiss, Rifkind, Wharton & Garrison; (15) Proskauer Rose Goetz & Mendelsohn; (16) Rogers & Wells; (17) Shearman & Sterling; (18) Simpson Thacher & Bartlett; (19) Sullivan & Cromwell; (20) White & Case; and (21) Winthrop, Stimson, Putnam & Roberts. Edward A. Adams, *N.Y. Firms are Hit First; Malpractice Hikes to Spread?*, NAT’L L.J., Oct. 26, 1992, at 15.

<sup>35</sup> Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #32, at 8 (June 7, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #32] (“BAR is, it’s a group that consists of 16 or I believe it’s now 16. It might be 17 of the leading New York firms.”).

<sup>36</sup> Mary Ann Galante, *Malpractice Rates Zoom: Legal Insurance Crisis*, NAT’L L.J., Jun. 3, 1985, at 19.

<sup>37</sup> See [http://www.reedsmith.com/thomas\\_igoe/](http://www.reedsmith.com/thomas_igoe/) [[https://perma-archives.org/warc/RSV6-N8RZ/http://www.reedsmith.com/thomas\\_igoe/](https://perma-archives.org/warc/RSV6-N8RZ/http://www.reedsmith.com/thomas_igoe/)] (last visited June 12, 2016), (identifying Mr. Igoe as of counsel to Reed Smith and President and Chairman of MPC Insurance, Ltd. and reporting that MPC is “a Vermont captive insurance company owned by 9 national and international law firms that provides professional liability insurance coverage for more than 7,000 attorneys practicing in the United States and in many foreign jurisdictions.”).

elsewhere.<sup>38</sup> The third, Attorneys Insurance Mutual Risk Retention Group (AIM), was formed in 1985 by a group of 21 California-based law firms with about 1500 lawyers.<sup>39</sup> AIM now has 13 law firm members with about 2600 lawyers.<sup>40</sup>

The three differ from ALAS in a variety of other ways in addition to their size and geographic concentration. First, rather than an internal staff, they are staffed by people from a major insurance brokerage firm, with leadership and assistance from committees primarily composed of partners from member firms.<sup>41</sup> Aon manages BAR and AIM; Marsh manages MPC.<sup>42</sup>

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<sup>38</sup> Dorsey & Whitney, which is based in Minneapolis, has publicly identified that it is a member of MPC. Jay R. Lindgren, *Building the People's Stadium: Dorsey & Whitney LLP's Response to Request for Qualifications/Proposals to Serve as Legal Counsel to the Minnesota Sports Facilities Authority*, DORSEY & WHITNEY LLP 10, <https://www.scribd.com/doc/110875888/Dorsey-Whitney-legal-services-proposal> (last visited June 12, 2016). We infer that Reed Smith, which is based in Pittsburgh, is a member from the fact that the firm website indicates that the COO is a member of the MPC finance committee and a senior lawyer who is of counsel is President and Chairman of MPC.

<sup>39</sup> Debra Cassens Moss, *Going Bare: Practicing Without Malpractice Insurance*, 73 A.B.A.J. 82, 86 (1987) ("The Los Angeles firm of Manatt, Phelps, Rothenberg, Tunney & Phillips responded to high premiums by joining about 20 other California firms to form Attorneys Insurance Mutual Ltd."); Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview A with Respondent #10, at 6 (Sept. 16, 2014) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview A with Respondent #10] ("They had 21 firms; 1,500 lawyers, no capital.").

<sup>40</sup> LPL Ins. Interviews, Interview A with Respondent #10, *supra* note 39, at 9; Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview B with Respondent #10, at 7 (Sept. 16, 2014) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview B with Respondent #10]; *See also California Lawyer's Annual Professional Liability Insurance Report*, CAL. LAW., Feb. 2010 at 28, 28-29.

<sup>41</sup> *See* email from Respondent #16 (Jan. 5, 2015) (on file with authors) (confirming that Aon's role in managing BAR is widely known among LPL insurance professionals).

<sup>42</sup> Aon's large presence in the LPL market is attributable to Aon's acquisition of the Minet brokerage, which was originally based in Montreal, where it served as the North American point of contact for the London Market's extensive U.S. professional liability insurance customer base. The Business Insurance directory

In each case, the broker arranges for all of the LPL insurance of the member firms.<sup>43</sup> Second, all three have departed from strict unitary rating. Premiums for the lower levels of coverage start with a per lawyer unitary rate, but are adjusted using debits or credits that reflect unusually poor or unusually good claims experience.<sup>44</sup> Third, consistent with the active involvement of major brokers, all three provide access to higher level excess insurance; firms pay an individualized, risk-rated price for that coverage, with the mutual functioning as a purchasing group that seeks to ensure consistent access to the high levels of insurance needed, especially by many of the BAR and MPC member firms.<sup>45</sup>

The three also differ from each other in some ways. For example, the BAR insurance program consists of three-year LPL insurance policies, typically rolled over each year (meaning that members get new three-year

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of alternative risk financing facilities identify Marsh as the manager for MPC. *BI Directory of Alternative Risk Financing Facilities*, BUS. INS. (Nov. 12, 2000), <http://www.businessinsurance.com/article/20001112/ISSUE01/10001657>; See also Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #23, at 18-19 (June 28, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #23] (describing MPC as largely “self-administered” by the law firms).

<sup>43</sup> See *Id.* (“Well, they’re arrangers, I guess is the way I’d put it. They arrange different layers of insurance”); Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #5, at 17 (Nov. 7, 2013) (unpublished interviews, on file with authors).

<sup>44</sup> LPL Ins. Interviews, Interview with Respondent #32, *supra* note 35, at 11 (“[T]he way it basically works is that there is a unitary rating by the insurers across the group, but we have firms that have particularly favorable claims history effectively get a rebate that’s paid by firms that have particularly less favorable claims history.”).

<sup>45</sup> Tom Baker & Rick Swedloff, *Liability Insurer Data as a Window on Lawyers’ Professional Liability Liability*, U.C. IRVINE L. REV. 1273, 1287 n.44 (2016). While the total limits available to the firms are highly confidential, we can report that the amounts available are in the hundreds of millions of dollars. See Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #5, at 17 (Nov. 7, 2013) (unpublished interviews, on file with authors).

policies each year).<sup>46</sup> BAR has the option in any particular year not to roll over the policy into a new three-year policy with a new price, but rather to keep the same policy at the same price for one or two more years, providing protection against short term price increases.<sup>47</sup> In addition, BAR does not provide its member firms a complete layer of either primary or excess insurance. Instead, BAR participates as a minority interest in “quota share”

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<sup>46</sup> Adams, *supra* note 34, at 21; LPL Ins. Interviews, Interview with Respondent #32, *supra* note 35, at 8.

<sup>47</sup> As one of our respondents explained,

[I]t’s understood that [the three-year policy is] there basically to guard against what we would consider misbehavior by the insurers, mainly refusing to reduce rates during periods where clearly claims experience and their profitability merits it, or trying to make up in one year for losses.

We have an understanding with our insurers that the objective is that when they’re incurring losses, they will get premium increases, but they will have to be patient, and not try and make it all back in one year—that they’ll have to do it somewhat gradually—but that on the flip side, in a soft market, we will not try and extract for that one huge premium decrease in a space of a year. We will be patient on that end so that it does not shock them with the huge loss of income, premium income. . . .

Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #19, at 11 (June 18, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #19]. Another respondent told us an instructive story about a meeting with BAR members and Hank Greenberg, former head of AIG, at a time when Greenberg wanted to substantially increase premiums. Apparently, no one told Greenberg that the BAR had a three-year policy, so his attempted bullying was ineffective: the BAR firms responded, first, by exercising the option to keep the AIG coverage in place at the then current price and, soon after, by replacing AIG in the BAR program. *See* Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #34, at 4-6 (June 18, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #34].

primary and excess layers of insurance, with the majority interest provided by commercial insurers – either stock companies or Lloyd’s syndicates.<sup>48</sup> The “lead insurer” sets the price for each layer.<sup>49</sup>

MPC provides its primary layer of insurance through a commercial insurance policy issued by Lexington Insurance Company, a company in the AIG insurance group with a very high credit rating, that is 100% reinsured by MPC.<sup>50</sup> In this kind of “fronting” insurance arrangement (which is a relatively common approach for large scale commercial enterprise), the law firms get the benefits of mutual insurance and a high credit rating, without the mutual needing to go through the effort required to get its own credit rating. In addition, MPC has an annual member auditing process that is more extensive than the others.<sup>51</sup>

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<sup>48</sup> LPL Ins. Interviews, Interview with Respondent #32, *supra* note 37, at 9 (“There is a piece of every firm’s cover that is actually written and retained by BAR.”). In a quota share insurance arrangement, a group of insurers each takes a share of the risk in a layer of insurance, similar to the way that a Lloyd’s syndicate operates. For example, the New York Law Journal reported in 1993 that BAR was responsible for 10% of the \$20 million primary insurance lawyer, 7.5% of the first layer excess insurance policy of \$20 million, and 15% of a second layer excess insurance policy with an unspecified limit. Edward A. Adams, *Paul Weiss Payout in RTC Accord Put at \$2 Million*, N.Y. L.J., Oct. 1, 1993, at 21.

<sup>49</sup> See Edward A. Adams, *Lawyers’ Malpractice Premiums Drop at Last; Decline, First in 10 years, after 1,000% rise*, N.Y.L.J., Dec. 12, 1994, at 21 (reported that BAR switched the lead primary position from one Lloyd’s syndicate to another in 1993 because the former syndicate refused to continue to offer three-year policies).

<sup>50</sup> *Financial Data for Lexington Insurance Company*, FLA. SURPLUS LINES SERVICE OFFICE, <http://industrydata.fslso.com/InsurerFinancials/findata.aspx?id=57> (last visited June 12, 2016) (reporting that Lexington Insurance Company was rated A by A.M. Best Rating in 2015). Lindgren, *supra* note 38, at 10 (“Dorsey’s professional liability insurance carrier is MPC Insurance Ltd, with the front carrier being Lexington Insurance Company and excess policies written by many other insurers.”).

<sup>51</sup> A respondent who is not associated with MPC described the process to us as follows:

Finally, AIM retains significantly less risk than MPC or BAR. Although AIM offers its members a \$9 million primary insurance policy, it supports that policy by buying reinsurance in the commercial insurance market.<sup>52</sup> Thus, as compared to the other small mutuals, AIMs risk transfer arrangements are more like a group purchasing service than a mutual insurer.

#### C. THE RISK PURCHASING GROUP: PILOTLEGIS

PilotLegis is the trade name of a risk-purchasing group that functions in many ways like the three smaller mutual insurers. Unlike the other groups, however, PilotLegis does not assume any risk, though it reportedly has an

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It's pretty intrusive. They have sit-down meetings with people and they can walk through the hallways, apparently, and pick somebody out of thin air and start interviewing them, asking them if they've read the manual, do they understand whatever issues they're dealing with at the time.

LPL Ins. Interviews, Interview B with Respondent #10, *supra* note 40, at 4. A commercial insurance executive provided a similar account:

I will tell you that if you talk to the MPC people—and you probably can—they've had unbelievably good results, at least they had when I was looking at them—even though some of their firms like [] have seen some tough days, they would argue that it was all about peer review. It was all about their ability to ask questions that no firm was gonna answer an insurance underwriter about. Now I would argue you can ask those questions if there's ten of you and you're all going to the Olympic Club together.

Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #16, at 20 (November 16, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #16]. ALAS also has extensive member audits, but on a less frequent basis.

<sup>52</sup> LPL Ins. Interviews, Interview B with Respondent #10, *supra* note 40, at 16.

organizational structure in place that would allow it to assume risk if it were unable to obtain adequate insurance in the commercial market.<sup>53</sup>

PilotLegis has 39 member firms, all of which are mid-sized law firms (20-200 lawyers), with a total of about 1600 lawyers, with about half practicing in California.<sup>54</sup> Aon manages PilotLegis.<sup>55</sup> Aon plays a larger role in setting the agenda for PilotLegis than the broker/manager in any of the small mutuals, but law firm members are actively involved in creating and maintaining the culture.<sup>56</sup>

The PilotLegis website contains the following statement from its chairman (Jeffrey Sharp, managing partner of a Chicago-based intellectual property firm) about the group's approach:

Through group purchasing power, our members enjoy preferential treatment in the LPL marketplace, more predictable pricing, and a stable source of insurance. Member firms also learn from each other in a myriad of ways, including the sharing of risk management and practice management procedures, a cornerstone of the program.<sup>57</sup>

The website describes the group's pricing approach as follows:

PilotLegis was not designed to "beat the market," but rather, offers stability through both multiyear and annual policies at competitive, intelligent terms. Where PilotLegis is different is in our approach to risk management. We have a passion for helping law firms identify and reduce their risk, leading to fewer claims, better service for claims when they do arise, and stronger long-term relationships with

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<sup>53</sup> *Attorneys' PG Positioned to Become RPG When Market Hardens*, 13 RISK RETENTION REP., Dec. 1999 (describing PilotLegis's preliminary plan for conversion to an RRG).

<sup>54</sup> See *Member List*, PILOTLEGIS, <http://www.pilotlegis.com/members/memberlist> (last visited June 7, 2016).

<sup>55</sup> See generally *AonPartnership with PilotLegis RPG*, PilotLegis, <http://www.pilotlegis.com/Templates/media/PDF/AonDescription.pdf> (describing the services Aon provides for PilotLegis).

<sup>56</sup> *Letter from our Chair*, PILOTLEGIS, <http://www.pilotlegis.com/who/letter> (last visited June 7, 2016) (describing the important role PilotLegis's members have played in creating and maintaining its culture).

<sup>57</sup> *Id.*



underwriters. ... Members understand that PilotLegis is not just an insurance product, but also a better way of doing business.<sup>58</sup>

D. PLUG – THE PROFESSIONAL LIABILITY UNDERWRITING GROUP

The final LPL mutual is the Professional Liability Underwriting Group, which issued insurance policies from the mid-1980s liability insurance crisis through 1991. PLUG was a captive insurer organized for a group of about 15 large law firms during the insurance crisis to plug a gap in a tower of insurance.<sup>59</sup> The choice of the name – PLUG – was intentional. The broker for the law firms involved – Minet, which is now owned by Aon – was unable to obtain coverage for the law firms in the commercial market for what was at the time a relatively high level excess layer of insurance. With Minet's help, the law firms created a captive that provided the missing layer of insurance, with the expectation that the captive would be used to "plug" the hole only as long as that layer could not be placed in the commercial market. As of 1992, the firms were able to obtain the coverage on acceptable terms in the commercial market, so PLUG stopped issuing new policies to its members.<sup>60</sup> Because PLUG was a short-term solution to a capacity limit in the commercial market, it did not have the other features of the other mutual insurers described in this section.

We include PLUG in our description of the forms of mutual insurance presently available in the LPL market because, once Minet (now part of Aon) paved the way, forming an entity like PLUG is always an option for a group of law firms. The fact that law firms have not done this in the 30 years since the liability insurance crisis strongly suggests that the commercial market is working adequately for the law firms that have chosen not to join, or are unable to join, one of the LPL mutuals. We return to what this means in Part V. In the next section we report what we have learned

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<sup>58</sup> *Id.* (answering the question of whether PilotLegis' insurance products are more affordable than competing products in the marketplace).

<sup>59</sup> The National Law Journal reported in 1992 that the members of PLUG were: Bingham, Dana & Gould; Breed, Abbott & Morgan; Cahill Gordon & Reindel; Dechert Price & Rhoads; Eckert Seamans Cherin & Mellott; Hale and Dorr; Irell & Manella; Kelley Drye & Warren; Latham & Watkins; McGuire, Woods, Battle & Boothe; Piper & Marbury; Skadden, Arps, Slate, Meagher & Flom; Thelen, Marrin, Johnson & Bridges; and Weil, Gotshal & Manges. *See Adams, supra* note 34, at 15.

<sup>60</sup> *Id.*

from our qualitative research about why law firms remain in the LPL mutuals.

#### IV. THE DEMAND FOR MUTUAL LPL INSURANCE

The first puzzle of mutual insurance in economic theory is easily stated: Because stock insurers are able to access all of the forms of capital available on the capital markets, they should – absent a market failure – be better able to spread risk than mutual insurers, which have access to more limited capital market instruments because of the requirement that mutuals must be owned by their members. The “puzzle” is: why are mutuals so prevalent in parts of the insurance market, given that they face this disadvantage?

The traditional answer is market failure. As insurance economics has long held, and as insurance professionals have understood for even longer, insurance markets are prone to market failure.<sup>61</sup> Prior work in the law and economics literature, most notably by Henry Hansmann, has identified a variety of market failure explanations for the formation and success of mutual insurance companies.<sup>62</sup> Our research suggests that three of these reasons apply to the LPL insurance market: adverse selection, moral hazard,<sup>63</sup> and a long-term contracting problem exacerbated by the claims-

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<sup>61</sup> See generally Baker, *On the Genealogy of Moral Hazard*, *supra* note 15 (discussing the history of the insurance market understanding of the problem of moral hazard and the importation of the concept into economics); Tom Baker, *Containing the Promise of Insurance: Adverse Selection and Risk Classification*, 9 CONN. INS. L.J. 371, 374-76 (2003) [hereinafter Baker, *Containing the Promise of Insurance*] (discussing the history of the insurance market understanding of adverse selection and the importation of the concept into economics).

<sup>62</sup> See sources cited *supra* notes 7, 11.

<sup>63</sup> For discussions on the problem of moral hazard, see, e.g., Kenneth Arrow, *Uncertainty and the Welfare Economics of Medical Care*, 53 AM. ECON. REV. 941, 961 (1963) (noting the problem of moral hazard as a major argument in favor of governmental provision of health insurance); KENNETH ARROW, *ESSAYS IN THE THEORY OF RISK BEARING* 142 (Markham Publ'g Co. 1971) (“[B]ut the insurance policy may, as we have seen, lead to a motive for increased loss, and then the insurer or risk-bearer is bearing socially unnecessary costs.”). For discussions on the problem of adverse selection, see, e.g., George A. Akerlof, *The Market for “Lemons”: Quality*

made form of liability insurance that became the prevailing form of professional liability insurance in the U.S. in the late 1970s.<sup>64</sup> In this section we report what we learned from our respondents about how the LPL mutuals address these problems. We then provide a new, autonomy explanation for the success of the mutuals that has not previously been reported in the literature.

#### A. LONG-TERM CONTRACTING

We begin with the mutuals' apparent comparative advantage in addressing the long-term contracting problem because that was what our respondents most emphasized about the benefits of belonging to a mutual: a long-term relationship with an insurer that would remain in the LPL market no matter what. The long-term, contingent nature of insurance relationships creates a number of challenges for both insurers and policyholders. Policyholders pay premiums for a promise that insurers will provide coverage when called upon. But, because policyholders have infrequent claims, it is often difficult to judge the value of the promise that insurance companies provide. Policyholders need to have insurance in place over

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*Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 492-93 (1970) (noting that absent countervailing efforts by insurance companies, the insurance pool will consist disproportionately of "lemons"—people with undesirable risk characteristics—due to adverse selection); *But see* Peter Siegelman, *Adverse Selection in Insurance Markets: An Exaggerated Threat*, 113 YALE L.J. 1223, 1224 (2004) (recognizing that the problem of adverse selection insurance markets may have been exaggerated since some features of insurance demand may undercut or reverse the typical adverse selection results). For historical review, *see* Baker, *On the Genealogy of Moral Hazard* Genealogy, *supra* note 15; Baker, *Containing the Promise of Insurance*, *supra* note 61.

<sup>64</sup> *See* George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521, 1526 (1987) ("At about the same time, in the early 1980's, insurers initiated efforts to restrict coverage levels in certain commercial lines by changing the terms of the basic policy from an occurrence to a claims-made basis."); Hansmann, *The Organization of Insurance Companies*, *supra* note 7, at 129 (noting that the central problem of long-term contracting in life insurance "lies in making provision for the insurance company to maintain financial reserves adequate for paying off claims").

periods for which it is not possible to have a fully specified contract. There are too many things that could change to allow insurers to provide a fixed price in advance, and specifying a formula in advance to account for all the potential changes seems to be nearly as difficult.<sup>65</sup> Accordingly, policyholders worry that insurers will not stand by them if claims emerge, that prices will spike for either endogenous or exogenous reasons, or that insurers will drop the line of insurance altogether. Insurers, on the other hand, worry about the adverse selection that results when the good risks drop out of the insurance pool over time.<sup>66</sup>

Many of our respondents report that they believe mutual insurance solves some of these problems. A general counsel who was involved in the founding of one of the small mutuals put it this way:

By grouping together we could, and acting as a buyer group we would, have greater market power than each firm does individually. The animating principal behind [mutual] is very much one of creating a stable insurance environment for all of its members. I think we all accept that we may be paying a little bit of a premium over what at least those of us that have better claims records could get in the open market for the benefit of having that stability.<sup>67</sup>

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<sup>65</sup> On the long-term uncertainties of liability insurance, *see generally* Tom Baker, *Insuring Liability Risks*, 29 GENEVA PAPERS ON RISK AND INS. 128 (2004) (explaining how a long duration of liability magnifies development risks, contract risks, and financing risks for liability insurance). On the long-term uncertainties of life insurance, *see* Hansmann, *The Organization of Insurance Companies*, *supra* note 7, at 129-31 (explaining the uncertainties of long-term contracting for life insurance).

<sup>66</sup> This concern, first expressed by life insurance companies in the 19th Century, is the source of the label “adverse selection.” Life insurance underwriters wondered why the mortality of their carefully “selected” policyholders turned out to be no different than that of the population as a whole. They reasoned that there was a contrary “adverse selection” force operating on their policyholder pool over time, as the healthy people dropped out and bought new policies that required a new medical exam. *See* Baker, *Containing the Promise of Insurance*, *supra* note 61.

<sup>67</sup> Interview with Respondent #32, LPL Ins. Interviews, *supra* note 35, at 8. Rappaport found similar explanations for the success of mutual insurers formed by municipalities. *See, e.g.,* Rappaport, *supra* note 15, at 1563

A second law firm general counsel reported:

I've never made a close study of the commercial premiums that we would pay versus what we're paying with [mutual], because I think ... it's the wrong question to ask. ... The question to ask is: Will this carrier be there when the crunch comes?<sup>68</sup>

A long time LPL insurance broker concurred:

I mean, the market's been so soft for so long. I mean, any law firm could pick up the phone, probably save ten percent just by making one phone call. It's kind of just the way the market is. No, they're—the idea with [mutual] and the other groups is they're pitching stability and sort of pricing continuity and your ability to buy the coverage so you're not going to find yourself whipsawed in a market that, where—as you used the example of the PLUG group, where you got capacity one day and the next day it's gone.<sup>69</sup>

Finally, yet another law firm general counsel explained, “there are plenty of terrific commercial insurers out there,” but “they have varying degrees to which they are committed to the professional liability market,” and “you don't want to be hooked up in a substantial way with an insurer that decides it doesn't want to write this kind of insurance anymore or having nothing to do with your particular firm.”<sup>70</sup>

Prior work has examined the long term contracting problem in relation to life insurance, but, as our respondents emphasized, liability insurance presents this problem, too. Indeed, if there is a single dominant theme about the benefits of belonging to an LPL mutual insurer, it is stability. This emphasis on stability addresses three interrelated concerns: 1) that

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(“[U]nlike the commercial insurers, which come and go from the market as they ride the insurance cycle, pools are there ‘through thick and thin.’”).

<sup>68</sup> Interview with Respondent #24, LPL Ins. Interviews, at 6-7 (July 12, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #24, LPL Insurance Interviews].

<sup>69</sup> LPL Ins. Interviews, Interview B with Respondent #10, *supra* note 40, at 12-13.

<sup>70</sup> Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #30, at 10 (May 29, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #30].

short-term idiosyncratic events will change the price that a firm pays for insurance; 2) that insurers will act opportunistically or leave the market if a “hard market” arises; and 3) that changing insurance policies or insurance carriers, whether in a hard market or otherwise, will expose firms to uncovered losses.

**More stable pricing.** Liability insurance pricing is a very complicated topic that does not need to be probed deeply to understand the mechanism by which mutual insurers provide stable pricing and why law firms value that stability. The two main mechanisms are the unitary (or quasi-unitary) pricing described earlier and the mutuals’ willingness to lag the pricing changes in the commercial LPL market as liability insurance prices move through the “boom” and “bust” swings of the liability insurance underwriting cycle.<sup>71</sup> Unitary or quasi-unitary pricing moderates the short-term impact that a large claim or set of claims could have on the price of any individual law firm. The willingness to lag the market through the underwriting cycle means that law firms have time to adjust to long term changes in the liability insurance prices. Both of these mechanisms are only sustainable when the members of an insurance pool credibly commit to remain in the pool even when some members of the pool are thereby required to pay more for their insurance than they could pay elsewhere.<sup>72</sup>

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<sup>71</sup> See Baker, *Underwriting Cycle*, *supra* note 22, at 396; See also Scott E. Harrington, *Tort Liability, Insurance Rates, and the Insurance Cycle*, in BROOKINGS-WHARTON PAPERS ON FINANCIAL SERVICES 97 (Robert E. Liton & Richard Herring eds., 2004) (discussing the volatility in premiums, coverage availability, and insurers’ reported profits in the context of expanding tort liability).

<sup>72</sup> This commitment to the pool is credible given the stability of the membership of ALAS, BAR, and MPC since their genesis regardless of the difference in claims experience. The extent of the commitment to ALAS, for example, which has the purest unitary pricing regime, can be seen in the report from a senior executive at a leading commercial insurer who said that “squeaky clean firms” – i.e., “a firm [with] 10 years of loss experience and never had a claim over the retention” – that bought insurance in the commercial market in 2014 were “probably paying about 30, 35 points off the ALAS rate.” Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #18, at 11 (Dec. 20, 2013) [hereinafter LPL Ins. Interviews, Interview with Respondent #18]. Our sense is that the LPL mutuals do not attempt to protect firms from changes in industry-wide risk, except as part of an overall effort to smooth year-to-year changes in

The long-term commitment of their members allows the mutuals, in turn, to commit to long term relationships with the commercial insurers and reinsurers in their program. The general counsel in a firm in one of the small mutuals explained this benefit as follows:

[R]emember, in the [small mutual] context, I am looking to have a viable commercial insurer forever. I'm not looking to hit the insurer for a big loss. Then they up my premium, and I say, "Sayonara, it was nice to know you," and I give my business to somebody else. I am looking for them to make a reasonable level of profit. We can argue over reasonable, but a reasonable level of profit over a sustained period, hopefully with minimum losses, so that everyone in their shop is usefully employed and happy, and that I am not subject to the vagaries of folks that can hurt me in knowing that I've got cover by taking unreasonable positions that I'm not covered at all.<sup>73</sup>

The program administrator from PilotLegis made this point directly in an interview with the trade press: "In times when premiums are low, we are not going to be paying the lowest, but in hard times, we will not be paying the highest."<sup>74</sup>

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premiums. In that regard, the LPL mutuals follow what sociologists Richard Ericson and Aaron Doyle described as an "absorbing risk" approach to risk management, helping the members of the mutual prepare for and bear their share of non-firm specific increases in lawyers' liability risk. *See* RICHARD V. ERICSON & AARON DOYLE, *UNCERTAIN BUSINESS: RISK, INSURANCE, AND THE LIMITS OF KNOWLEDGE* 180 (2004) (noting that one approach insurers used to deal with the uncertainties of earthquake is to absorb its risk in advance, through capital protection, capacity building, and the design and construction of the built environment).

<sup>73</sup> LPL Ins. Interviews, Interview with Respondent #34, *supra* note 47, at 15.

<sup>74</sup> Margaret Hepper, PilotLegis's program administrator, explains how PilotLegis has focused on the good underwriting results, even with the pressure of the soft market:

"When Pilot formed," says Hepper, "the members wanted to control how they purchased insurance." She notes that the founders of PilotLegis sought to establish predictability and stability in professional liability insurance irrespective of market conditions and

***Commitment to the market.*** The most important aspect of the stability provided by mutual insurers, according to our respondents, is long term commitment to the LPL market, regardless of insurance market conditions. Law firms express concerns about insurers' long term commitment to the LPL market particularly because of a concern that there could be another liability insurance crisis.<sup>75</sup> ALAS, MPC, AIM and BAR were formed when the liability insurance crisis of the mid 1970s was a recent memory, and they famously protected their members in the liability insurance crisis in the mid-1980s, which was the most extreme event in the U.S. liability insurance market since industry wide data have been collected.<sup>76</sup>

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formulated an agreement with its underwriters that the group's premiums would experience controlled changes thereby avoiding the severe price swings of the open market. Hepper says that, "In times when premiums are low, we are not going to be paying the lowest, but in hard times, we will not be paying the highest."

*Attorneys' PG Positioned to Become RRG When Market Hardens, supra* note 53.

<sup>75</sup> See sources cited *supra* note 71.

<sup>76</sup> *From Industrial Insured Captive to Risk Retention Group: What's Life Like Now?*, 11 RISK RETENTION REP. Feb. 1997 (introducing the historical background on the evolution of ALAS); Baker, *The Shifting Terrain of Risk and Uncertainty, supra* note 22, at 33 fig.3 (showing that the mid-1980s experienced the most dramatic changes in real aggregate premiums for liability insurance). In the "non-statutory" lines of liability insurance (i.e. other than auto and workers compensation) the total amount of premiums collected in the U.S. market as a whole at that time more than doubled over a two-year period. This statistic understates the increase in insurance prices during that period, because the supply of insurance – i.e. the amount of insurance that the publicly reporting insurers could write at any price – shrunk during this period. This means that insurance prices increased by more than the total amount of premiums paid and, thus, that insurance purchasers paid much higher premiums for less total coverage. *Id.* at 536 ("During a 'hard market,' prices significantly exceed costs and insurers can implement new restrictions on coverage and underwriting."). The publicly available information about insurance premiums is taken from financial reports that provide only the aggregate premiums collected, not the prices charged for that insurance.



This commitment is credible because, unlike the stock insurers and London Market syndicates that constitute the commercial insurance market, the mutual insurers do not have the option of withdrawing their capital from LPL insurance and moving into another market. Moreover, because the members own the mutual, there is less concern that the insurer will behave opportunistically vis-a-vis the policyholders when things change either with the firm or with the market. This stability allows the mutual insurers and their (re)insurance partners to adjust prices over time to bring long-term losses and premiums into alignment despite unanticipated changes in law firm or underwriting cycle risks.

**Protection from continuity risk.** A third aspect of the stability provided by mutual insurers is protection from what the insurance trade literature refers to as “continuity risk.” This is the risk that a claim may fall into a coverage gap created by the fact that liability insurance policies provide coverage for a comparatively short period.<sup>77</sup> This risk comes from the structure of claims-made liability insurance. Claims-made policies generally includes policy provisions that are intended to protect insurers against adverse selection, but that can be invoked in situations in which that underlying purpose does not apply, especially if a law firm switches from one insurer to another. To illustrate that concern, one general counsel referred to the “horror story” of the Philadelphia law firm Pepper Hamilton, which had a coverage dispute with its commercial insurers about whether a claim should have been filed in a prior year.<sup>78</sup>

The mutual insurers address continuity risk by keeping the same primary insurance contract in place for a very long time, by credibly committing to avoid contesting coverage for a claim based on the kinds of technicalities that produce continuity risk,<sup>79</sup> and by making sure that the

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<sup>77</sup> Wayne E. Bernstein, *Ensuring Continuity of Coverage in D&O and EPLI Policies*, PROP. CASUALTY 360 (Aug. 1, 2005), <http://www.propertycasualty360.com/2005/08/01/ensuring-continuity-of-coverage-in-d-o-and-epli-policies>. See also Michael F. Schleigh, *Owning up to Attorney Failures: The Need to Disclose Potential Liabilities When Applying for Malpractice Policies*, 39 BRIEF 44, 44 (2010) (noting that law firms must fully disclose potential problems in order to avoid falling into a coverage gap).

<sup>78</sup> Exec. Risk Indem., Inc. v. Pepper Hamilton LLP, 919 N.E.2d 172 (N.Y. 2009).

<sup>79</sup> Because the mutuals purchase reinsurance from the commercial market and, except for ALAS, arrange excess insurance on behalf of their

excess policies that their members purchase are true “follow form” policies – meaning that the excess policies have exactly the same terms and conditions as the primary policy. Notably, the one large law firm mutual that doesn’t provide its own primary layer of insurance – BAR – buys three year policies and takes a significant share of the risk under those policies as a way to obtain favorable, consistent policy terms and favorable, consistent insurance coverage determinations by the commercial insurers in their program.<sup>80</sup>

**Summary.** Whether our explanation is accurate or not, the stability the mutuals have experienced is remarkable. Above all, members tend to remain members. As an illustration, ALAS reports that the decline in the number of law firm members from a high in 1991 is largely attributable to consolidation among member firms (the total number of lawyers ALAS insures has increased since then), and that when non-member firms merge with member firms the resulting merged firm almost always remains an ALAS member.<sup>81</sup> BAR members appear to be as loyal, or perhaps even more loyal than ALAS members. While 4 of the original 21 member firms have dissolved and two other member firms merged with firms that have different LPL insurance traditions, the rest remain BAR members – a full 36 years

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members, they cannot ignore contractual requirements, but what they can do is to employ the most favorable continuity risk conditions and exclusions in their policies, conduct regular counseling on how to comply with the continuity risk conditions, take the most favorable position on what constitutes compliance with those conditions and, in general, look for coverage. See Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #52, at 10-11 (June 21, 2016) [hereinafter LPL Ins. Interviews, Interview with Respondent #52].

<sup>80</sup> See *supra* Part III.B.

<sup>81</sup> The current count of member firms is down from a high of 374 firms in 1991, largely as a result of the consolidation of the legal market during that period, rather than the loss of members to the commercial market. ALAS reports that most of the reduction in member firms is attributable to mergers, and that, on the whole, mergers have resulted in an increase in the number of lawyers that ALAS insures. The current count of lawyers is down from a high point of 63,420 in 2008, largely as a result of attrition at member firms following the financial crisis of 2008. ATTORNEYS’ LIAB. ASSURANCE SOC’Y LTD., 2010 ANNUAL REP. 5 (2011). (notes on “Membership Activities”).

after formation.<sup>82</sup> MPC appears to have a similar record. Two members left to join AIM (reportedly because they were more similar to the mid-sized firms in AIM than the very large firms that predominated in MPC), and other firms have failed, but no firm has left for the commercial market or to join ALAS.<sup>83</sup> Indeed, when MPC members have merged with or joined other firms, the combined firm has remained an MPC member.<sup>84</sup>

## B. ADVERSE SELECTION

From an insurance economics perspective, the long-term contracting problem is one kind of adverse selection problem. Nevertheless, we addressed it separately and first because that is how our respondents explained the benefits of mutual LPL insurance to us. The insurance economics explanation is as follows. Insuring against legal malpractice risks requires longer term relationships than are possible to fully specify in advance. Law firms rationally worry that their insurers will turn out to be “lemons” – abandoning them if claims emerge, unreasonably or

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<sup>82</sup> Of the original 21, the four that dissolved are Dewey, Donovan, Lord Day, and Mudge Rose; the two that merged with firms known to obtain their insurance in other ways are Rogers & Wells (merged with the UK firm Clifford Chance) and Winthrop Stimson (merged with Pillsbury, which remains a member of MPC, as indicated by the report on the firm’s website that the General Counsel is on the board of directors of MPC). We understand that at least one firm has joined since the list was published in 1992.

<sup>83</sup> LPL Ins. Interviews, Interview A with Respondent #10, *supra* note 39, at 10 (reporting on firms leaving MPC for AIM).

<sup>84</sup> We infer that Reed Smith joined MPC when it absorbed a group of lawyers from Thelen. *See* Christie Smythe, *Thelen Secures Exit from Loewens Bond Offering Suit*, LAW360 (June 2, 2010, 5:50 PM EDT), <https://www.law360.com/articles/172529/thelen-secures-exit-from-loewens-bond-offering-suit> (reporting that MPC was Thelen’s insurer). Pillsbury Winthrop Shaw Pittman is a member of MPC. Pillsbury was a founding member of MPC that later merged with BAR member Winthrop Stimson and ALAS member Shaw Pittman. *See* ATTORNEYS’ LIAB. ASSURANCE SOC’Y LTD., 1998 ANNUAL REP. 55 (1999) (listing Shaw, Pittman, Potts and Trowbridge as an ALAS member); List of BAR member, *supra* note 5 (listing Winthrop Stimson as a BAR member).

unexpectedly raising prices, or exiting the legal malpractice insurance market altogether. Insurers, on the other hand, rationally worry that the good law firm risks will drop out of the insurance pool leaving them with the “lemon” law firms. The LPL mutual insurers address this adverse selection problem by credibly committing to remain in the market and by formal and informal structures that sufficiently commit the low risk firms to long term membership, as we explained in the prior section.

The LPL market also faces a more general adverse selection problem that is present in insurance markets even when there is no long term contracting problem. Given the potential information asymmetry between insurer and policyholder, insurance companies cannot perfectly differentiate between good risks and bad risks, with the result that they need to charge higher prices and provide less complete insurance than they would if they had better information.<sup>85</sup> Prior work has suggested that mutual insurers may have a comparative advantage over stock insurers in this regard because the members of a mutual may be better able to assess the risk posed by their fellow members and, correspondingly, more willing to open up to the mutual about their own risks. For example, Henry Hansmann theorized that firms that are part of an industry would be better at assessing the risk of other members of that industry than an insurer would be. Hansmann argued that “the cost of information about the riskiness of individual insureds [is] lower to firms within the industry than to those outside of it.”<sup>86</sup>

We find some evidence to support this theory in the structure of the mutual insurers, especially the smaller ones. The participating law firms know a great deal about each other outside of the membership and underwriting process, and they are better positioned than an insurance underwriter to use that process to uncover weaknesses that pose unusual liability risks. A partner in a small group mutual member firm described their comparative advantage as follows:

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<sup>85</sup> See Michael Rothschild & Joseph Stiglitz, *Equilibrium in Competitive Insurance Markets: An Essay on the Economics of Imperfect Information*, 90 Q.J. ECON. 629, 632 (1976) (noting that “those with high accident probabilities will demand more insurance than those who are less accident-prone”); Akerlof, *supra* note 63, at 493 (noting that “insurance companies are particularly wary of giving medical insurance to older people due to the problem of adverse selection,” and that this “principle of ‘adverse selection’ is potentially present in all lines of insurance.”).

<sup>86</sup> Hansmann, *The Organization of Insurance Companies*, *supra* note 7, at 146.

If I were a senior executive of a big [insurance] company in Europe, ... [and] could look at everything about the US market and say, "How do I judge which firms are good risks, which firms are not good risks?" It just so happens because of our group, we know how to make those judgments quite well, because we're dealing with people in our group that we've known for decades and we've all helped each other deal, or create first-rate risk management programs and claims handling programs and policy form. ... But I don't know how Swiss Re goes to New York and looks at—I'll just pick a name, cause they don't exist anymore—Dewey. I don't know how they do it. I'll never have to worry about it, cause we're just ahead of the curve. That's what we think.<sup>87</sup>

An executive in a commercial insurance company also observed that the smaller mutual insurers have an advantage over commercial insurers in underwriting:

I will tell you that if you talk to the MPC people—and you probably can—they've had unbelievably good results, at least they had when I was looking at them—even though some of their firms like [] have seen some tough days, they would argue that it was all about peer review. It was all about their ability to ask questions that no firm was gonna answer an insurance underwriter about. Now I would argue you can ask those questions if there's ten of you and you're all going to the Olympic Club together.<sup>88</sup>

A related selection advantage of the mutual follows from the time and energy that the mutuals demand of their members, especially in relation to loss prevention and claims review. Firms with a greater willingness to engage in these time consuming loss prevention activities may be more likely to join the mutual and more likely to stay in the mutual.<sup>89</sup> As one general

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<sup>87</sup> LPL Ins. Interviews, Interview with Respondent #26, *supra* note 16, at 14.

<sup>88</sup> LPL Ins. Interviews, Interview with Respondent #16, *supra* note 51, at 20.

<sup>89</sup> An economist would call this propitious selection on moral hazard. See Liran Einay, et al., *Selection on Moral Hazard in Health Insurance*, 103 AM. ECON. REV. 178, 178 (2013) (presenting empirical evidence) ("[I]ndividuals may select insurance coverage in part based on

counsel explained in response to our question about why he had not recommended that his firm join ALAS, “Joining ALAS meant a kind of commitment of time and energy that I think a lot of people just didn’t feel like making.”<sup>90</sup> The willingness to make that commitment may signal that the firm is a better fit for ALAS, both in terms of commitment to loss prevention and to a long term relationship with ALAS.

In addition to engaging in careful selection of its members, a mutual insurer could also combat adverse selection by promoting a sense of solidarity among its members that makes them more willing to share information about their risks and more willing to make a long-term commitment to remain in the mutual. Consider the makeup of the mutuals as described above. BAR and MPC are a veritable who’s who of top firms in New York City and San Francisco. Over one-third of ALAS members are on the AmLaw 200 and they represent one-quarter of all firms over 1,000 lawyers.<sup>91</sup> Further, AIM and ALAS (which appear to be more actively interested in new members than BAR or MPC) are notoriously careful in selection, which provides some support for this theory.<sup>92</sup> This selectivity creates a sense that member firms are living up to certain professionalism standards and promotes a sense of solidarity that encourages the sharing of risk-related information:

You probably have a conception of your peer group—either your Penn Law peer group or in-your-field peer group. We probably have a view of that, that cuts across quality, the competence, and there is a kind of a view that there’s a slight—we’re still a little old-fashioned—where culture actually matters. It’s thought to be a good thing that when you have a partners’ meeting, everyone actually can sit around the same table. ... There is this sense in which a little pride of culture matters. The profession has actually been experiencing a

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their anticipated behavioral (‘moral hazard’) response to insurance, a phenomenon we label ‘selection on moral hazard.’”); David Hemenway, *Propitious Selection*, 105 Q.J. ECON. 1063 (1990).

<sup>90</sup> Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #21, at 10 (Dec. 18, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #21].

<sup>91</sup> See *supra* note 5.

<sup>92</sup> For a discussion on ALAS’s selectivity, see *supra* note 26. See also LPL Ins. Interviews, Interview A with Respondent #10, *supra* note 39, at 8.

decline in professionalism and becoming more and more like accounting firms. That's a bad thing. It's bad for the quality of life. It's bad for the quality of representation. It's bad for risk. It's terrible for associates. I would say there's a certain way in which there's a high degree of homogeneity on that, as expressed.<sup>93</sup>

I mean one of the reasons that these firms are comfortable with each other is we're all comfortable that each of us values our reputations. Putting aside claims experiences, etc., we're all comfortable that each of the members of the group believes in risk management, simply in terms of preserving their reputations as firms that don't do the sorts of things that expose them to malpractice claims.<sup>94</sup>

[W]e created the [mutual] because of our desire to be able to control our own at least primary layers of insurance, control the terms and conditions of our policies and see that all the members of the group lived up to the kind of risk management that we all believe in. That's exactly why we did it.<sup>95</sup>

ALAS, as you probably know, but if you don't, I can give you all this information about it—that's really kind of a band of brothers type approach. They would do a lot of peer review and those sorts of things.<sup>96</sup>

Of course, this is not solidarity with the legal profession as a whole, but rather solidarity with the slice of the legal profession that forms the

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<sup>93</sup> Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #35, at 12 (May 28, 2015) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #35].

<sup>94</sup> LPL Ins. Interviews, Interview with Respondent #19, *supra* note 47, at 12.

<sup>95</sup> LPL Ins. Interviews, Interview with Respondent #26, *supra* note 16, at 6.

<sup>96</sup> LPL Ins. Interviews, Interview with Respondent #16, *supra* note 51, at 4.

membership of the mutual. That slice is a comparatively elite one, with the associated elitism serving as part of the attraction of the mutual.<sup>97</sup>

### C. MORAL HAZARD

This solidarity is also part of the reason why mutual insurers may also be better at managing the potential moral hazard of LPL insurance. As insurance scholars know well, moral hazard presents potential problems for both the insurer and the policyholder.<sup>98</sup> Insurers worry that indemnification will cause policyholders to take less care to avoid causing harms and will take less care to minimize those harms that do materialize. Policyholders worry that insurers will take their money up front and then, when claims come in, refuse to provide, or only reluctantly or partially provide, the coverage for which the parties bargained. We find evidence that the LPL mutuals may have a comparative advantage in addressing both these aspects of moral hazard.

**Loss Prevention.** Insurers have a number of tools to manage policyholder moral hazard, including pricing on risk, underwriting, contract design, claims management, loss prevention, research and education, and engagement with policy makers, as we've discussed elsewhere.<sup>99</sup> Although

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<sup>97</sup> One law firm general counsel, not an ALAS member firm, described the attraction of ALAS, only partly tongue in check, as follows: "It's a cool thing to be a part of. ALAS is for the studly firms." See notes from conversation with Respondent #35 (Nov. 10, 2015) (on file with authors). See also LPL Ins. Interviews, Interview with Respondent #35, *supra* note 93, at 3 ("[I]t's a good idea to be a part of it, but I think that's what it is. It's not a brand. I would guess some people are all proud that they're members of ALAS, it means they're one of the big boys."). For a recent review of the stratification of the U.S. bar, see JOHN P. HEINZ & EDWARD O. LAUMANN, CHICAGO LAWYERS: THE SOCIAL STRUCTURE OF THE BAR 37-45 (Am. B. Found. 1994).

<sup>98</sup> See generally Baker, *On the Genealogy of Moral Hazard*, *supra* note 15; CAROL A. HEIMER, REACTIVE RISK AND RATIONAL ACTION: MANAGING MORAL HAZARD IN INSURANCE CONTRACTS 29-31 (U.C. Press 1985) (noting that the moral hazard contains a matter of choice and can affect the policyholder's action, which will further change the odds and severity of a covered peril and lead to different reactions of the insurer).

<sup>99</sup> Baker & Swedloff, *supra* note 15 (identifying risk-based pricing, underwriting, insurance contract design, claims management, loss



LPL insurers use these tools to varying degrees, our respondents report that they believe that one of the primary benefits of being part of ALAS—and most of the smaller mutual insurers—is superior loss prevention services.

Our research suggests that law firms want help with loss prevention and that the provision of those services binds the members to the mutual. In that regard, it is important to be clear that none of our respondents suggested that there is a classic *ex ante* moral hazard problem with regard to LPL insurance. If anything, the emphasis that law firms place on LPL insurers' commitment to loss prevention suggests to us that, to the extent that lawyers think about LPL insurance at all, those thoughts encourage greater care, not less.<sup>100</sup> Thus, the potential difference between stock and mutual insurers lies not in their ability to prevent lawyers from “slacking off” because of insurance but rather in their ability to encourage lawyers to do more.

ALAS, especially, has a reputation for providing high quality loss prevention services:

They're the best in loss prevention support and assistance. ... Not only their publications, they have seven or eight loss-prevention counsel who are all former partners in ALAS firms and are very experienced in the area. ... [Y]ou just call up, and you get an ALAS—sophisticated ALAS person—who will work through a problem with you; and if he or she doesn't know the answer, they'll caucus and get back to you.<sup>101</sup>

Why do we stay with ALAS? It's a couple of things. One is that they have outstanding loss prevention resources. I mean better than any other carrier or any other source we can imagine. They provide a lot of educational and a lot of backstopping, a lot of counseling, a lot of support for prevention activities. If I get a really thorny conflict question that I'm having difficulty with I can call any one of a

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prevention services, research and education, and lobbying for public safety regulation as the seven tools that insurers usually use to regulate their insureds).

<sup>100</sup> See also Baker & Swedloff, *supra* note 15.

<sup>101</sup> LPL Ins. Interviews, Interview with Respondent #24, *supra* note 68, at 6. See also, LPL Ins. Interviews, Interview with Respondent #30, *supra* note 70, at 10 (“We’re very satisfied with ALAS and I think it does a terrific job not only with respect to clients but with respect with loss prevention programs and so forth.”).

number of people up there and get a really, really thoughtful answer. That's nice.<sup>102</sup>

The smaller mutuals do not have the same internal loss prevention staff, but the three that are managed by Aon – AIM, BAR, PilotLegis – have access to Aon's loss prevention unit, which Aon created to compete with ALAS. In addition, the smaller mutuals hold loss prevention meetings and share loss prevention information. Moreover, the annual member-run audits of other member firms, especially those from MPC, provide opportunities for feedback on loss prevention practices. An attorney in one MPC member firm who claimed to be knowledgeable about ALAS loss prevention efforts, asserted that MPC's loss prevention efforts were more cutting edge and better tailored to the firms in MPC.

The ALAS firms have many programs, but I think we're just a little more nimble due to our small size, and we're very, very interested in the subject. Always have been. That's why we did it this way, so we—I think we stayed with the cutting edge of what's going on in law firm risk, as well as just good practices. Not just avoiding risk, but good practices that promote the highest ethical behaviors and identifying issues as they come along.<sup>103</sup>

For our purposes the truth of this assertion is less important than the value that it suggests MPC places on loss prevention. Actively participating in any of the LPL mutuals builds structured attention to loss prevention into the busy professional lives of the law firm partners charged with carrying out the firms' obligations to the mutual.<sup>104</sup>

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<sup>102</sup> Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #28, at 11 (May 8, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #28].

<sup>103</sup> See LPL Ins. Interviews, Interview with Respondent #26, *supra* note 16, at 14.

<sup>104</sup> One law firm general counsel made the point this way:

... Let me go a different way. If you ask the question, "What does a board of directors do for a corporation to management?" .... There's a lot of different kinds of things you can say. One of the things that happens is management has to show up on a periodic basis and just explain why it's doing what it's doing.... I have come

Law firms that buy strictly commercial report a different approach to loss prevention by their insurers, with less insight and fewer structured opportunities for firm lawyers to focus on risk management:

[Y]ou know about ALAS right, the co-op group? We've never been an ALAS firm. I have the impression just anecdotally that ALAS is much more hands on about stuff that its insureds do. I think they've expressed a view about whether you should have a mandatory arbitration provision in your engagement letter. Those are subjects that I've just never seen come up in some years I've been dealing with the insurers.<sup>105</sup>

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to believe that having, if you're management, having to come and just sit down and explain why you're doing what you're doing makes you better at what you do, in a pretty big way.

What's the analogy here? I can only go to two meetings a year. I listen to some stuff probably that I wouldn't hear otherwise. I think a little bit more about it. My firm wants me to write a one-page summary to report to the board. Just that attention focuses people to do a little better than they might otherwise. It doesn't actually take a great idea. That's sort of my point.

LPL Ins. Interviews, Interview with Respondent #35, *supra* note 93, at 21.

<sup>105</sup> Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #31, at 5 (June 4, 2013) (unpublished interviews, on file with authors). *See also* Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #33, at 9 (June 10, 2013):

Occasionally they make suggestions, although we are pretty far ahead of the curve, at least that's our perception, and that's reinforced by the carriers. It's fairly rare that we have a carrier pushing us to take a risk management step that we don't. It's more that they like to hear it and know what we're doing, so that they can calibrate how much capacity they wanna allocate to us, and what rates they feel like they need to justify that, I guess, the risk that we present.

It makes economic sense that the mutuals invest more in loss prevention than the commercials. First, the solidarity fostered by the mutuals make them better able to motivate meaningful risk reduction, increasing the return on their investment in loss prevention research and development. In that regard one respondent noted:

[I]n a group there's more likely to be peer pressure to do a better job and have fewer claims. I've seen it in real—these guys do not want to sit in a meeting and have their claim information up on the board. There's an incentive for them to go back to their firms and—I know a couple of firms that have taken all the information back to their partnership meetings and kind of laid it out there and said, "I don't want to be the poster child at the next board meeting. We got to do it better the next time." That sort of thing.<sup>106</sup>

Second, to the extent that there are longer-term relationships between the mutuals and their members the mutuals can expect to earn a greater return, in the form of lower losses, from a given investment in loss prevention.

***Policyholder Trust in the Claims Experience.*** With regard to moral hazard by insurers, law firms report higher levels of trust that mutual insurers will whole-heartedly perform when claims come it and, correspondingly, greater levels of concern about hesitation or outright opportunism by stock insurers.<sup>107</sup> Mutual members report that they value their membership in large part because of the high quality claims handling experience—both because they do not have to fear that the mutuals will deny their claims and also because of the manner in which the claims are handled.<sup>108</sup> In the words of one law firm general counsel, "[T]he intangible is the claims control. .... Who's your lawyer, and how much are they [the insurers] gonna screw

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<sup>106</sup> LPL Ins. Interviews, Interview B with Respondent #10, *supra* note 40, at 24.

<sup>107</sup> See, e.g., LPL Ins. Interviews, Interview with Respondent #28, *supra* note 102, at 12 ("I am . . . aware of just enough contrast in the commercial market that, to us, the way that [the mutual] handles claims is extremely important").

<sup>108</sup> See, e.g., *id.*; See also LPL Ins. Interviews, Interview with Respondent #23, *supra* note 42, at 19 ("I mean it's not—not to trash another company too much, but it's not like you hafta' call National Union and say, 'Help us settle this case.'").

around with your lawyer?”<sup>109</sup> Although there are significant differences in the claims handling approaches of the mutuals – with ALAS said to exercise the most centralized control over claims – our respondents who are members of, or work with, the mutuals stressed the quality of the claims experience.<sup>110</sup>

A general counsel of an ALAS member put it this way:

Even more important than [their outstanding loss prevention resources] is the claims handling function. I know all the ALAS claims attorneys. I’ve known them for years. They worked our claims, I worked with them when I represented other ALAS firms. I’ve seen them as outside counsel and inside counsel. They’re highly professional, very intelligent and they also are very supportive; ... they handle claims in a very good way. I just am aware of enough contrast in the commercial market that, to us at least, the way ALAS handles claims is extremely important. That relationship is worth it to us.<sup>111</sup>

Another general counsel in an ALAS member firm referred to the “horror story” of the Philadelphia law firm Pepper Hamilton, referred to earlier in our discussion of continuity risk.<sup>112</sup> He contrasted that experience with firms in ALAS:

There’s not the risk of coverage denial. There’s not the risk of being caught between years. .... It’s not the case with ALAS that when you

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<sup>109</sup> LPL Ins. Interviews, Interview with Respondent #35, *supra* note 93, at 18.

<sup>110</sup> See, e.g., LPL Ins. Interviews, Interview with Respondent #23, *supra* note 42, at 18-19 (“I think we get a lot of the benefits in how the claims are administered. . . . You get a very—it’s self-administered, meaning that there are no employees with this company. . . . They are very supportive and helpful.”); LPL Ins. Interviews, Interview with Respondent #26, *supra* note 16 and accompanying text.

<sup>111</sup> LPL Ins. Interviews, Interview with Respondent #28, *supra* note 102, at 12.

<sup>112</sup> See LPL Ins. Interviews, Interview with Respondent #52, *supra* note 79, and accompanying text.

give them a claim that they're looking at the claim with a reason to turn it down. They are in it for the long term.<sup>113</sup>

Criticizing commercial insurers' claims practices is one topic on which the members of ALAS and the smaller mutuals agree. The general counsel of one member of a small mutual reported:

[Mutual] is . . . very supportive and helpful. I mean it's not—not to trash another company too much, but it's not like you have to call National Union<sup>114</sup> and say, "Help me settle this case." If you're calling on one of your colleagues in another firm that you've been working with for the last 25 years—and so it's a very interactive approach to claims handling.<sup>115</sup>

While it is not possible for our qualitative research to prove or disprove these accounts, the money-for-promise nature of insurance can create an incentive for opportunistic behavior at the point of claim.<sup>116</sup> Insurance law and regulation attempt to reduce that opportunism, and insurance marketing is directed at alleviating policyholder concerns.<sup>117</sup> The fact that mutuals are owned by their members may reduce the opportunism incentive, because there are no shareholders whose interests are in conflict with the policyholders. While, of course, the membership as a whole may have adverse interests to the member with a particular claim, each of the members may face a claim in the future.<sup>118</sup>

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<sup>113</sup> Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #27, at 2 (Dec. 20, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #27].

<sup>114</sup> National Union is the name of a prominent commercial insurance company in the AIG group of companies.

<sup>115</sup> LPL Ins. Interviews, Interview with Respondent #23, *supra* note 42, at 18-19.

<sup>116</sup> Tom Baker, *Constructing the Insurance Relationship: Sales Stories, Claims Stories, and Insurance Contract Damages*, 72 TEX. L. REV. 1395, 1401-02 (1994) (explaining the tension in the relationship between insurance companies and their insureds within the money-for-promise arrangement).

<sup>117</sup> *Id.*, at 1403-07 (discussing how insurance advertisements address the theme of trust and dependence differently).

<sup>118</sup> A general counsel in another ALAS member firm expressed that point indirectly as follows:

Two corollaries to this point are the following. First, because of the long-term stability of their membership and their law firms' demonstrated willingness to pay a higher price for what is understood to be a higher quality relationship, mutuals have less concern that the higher costs associated with high quality claims handling will drive members away. Second, as discussed above, the relative homogeneity of the pool may make law firm members less concerned about *ex post* moral hazard, i.e. that certain members may take advantage of the high-quality claims experience by demanding more, or more expensive, defense services than reasonable.

D. PROFESSIONAL INDEPENDENCE

Our final explanation for the success of the mutual insurers is that member firms believe that participating in an LPL mutual promotes professional independence to a greater extent than buying purely commercial insurance. This professional independence explanation is complementary to the traditional market failure explanations just explored because it helps to explain why law firms might find it easier to accept a mutual insurers' efforts to manage moral hazard, adverse selection, and the long term contracting problem. To at least some degree, such efforts by insurers require asserting some control over, and thus limiting the autonomy of, their insureds. Adverse selection and the related long-term contracting problem leads insurers to

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I think there is—one of the arguments that commercial carriers make—we get solicited a fair amount—is, “If you come with us, you’re going to pay X dollars a lawyer, and that’s Y dollars less than what you’re paying at ALAS.” Well, that may be, but that doesn’t take into account the question as to whether or not this carrier is going to be there when a claim comes in. It doesn’t take into account the loss-prevention services. ... Do we pay for the loss-prevention services? Sure. We pay for it, but we’re not paying for Chubb’s—we’re not paying out anything to Chubb stockholders.

LPL Ins. Interviews, Interview with Respondent #24, *supra* note 68, at 6.

create structures that bind insureds to the pool.<sup>119</sup> Moral hazard leads insurers to emphasize loss prevention and claims control.<sup>120</sup>

When the insured and the insurer are part of the same profession, accepting some degree of control by the insurer – engaging in recommended loss prevention efforts, accepting control over the claims settlement process, and agreeing to organizational rules and contract terms that limit the freedom to change insurers – is likely to be less threatening to the insured. In that context, these apparently autonomy-reducing efforts can easily be understood and explained to recalcitrant partners as professional self-regulation or, less grandly, simply as smart law firm risk management.<sup>121</sup>

Whether this professional autonomy appeal is understood as a separate explanation or simply as a reason for the mutuals' comparative advantage in addressing the market failures as traditionally understood is less important to us than the resulting focus on the law firms participating in the mutuals. Loss prevention, solidarity, and long-term contracts are not something that the mutuals impose on recalcitrant members in return for providing risk distribution services. Instead, "You could say [mutual insurer] – which has its own officers and directors – pushes things to us, but **we** own it, and **we** direct it to do so."<sup>122</sup> One of the themes of our larger LPL research project, and a distinction between our work and much of the prior work in both the insurance as governance and the law and economics traditions, is

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<sup>119</sup> Baker, *Containing the Promise of Insurance*, *supra* note 61, at 375-76 (discussing the four approaches that insurers usually use to bind insureds to the pool as a solution to the problem of adverse selection).

<sup>120</sup> Baker, *On the Genealogy of Moral Hazard* Genealogy, *supra* note 15, at 280-82 (arguing that insurance is often conditioned on both the care to prevent a loss and insurers' controls over insureds' ability to recover loss).

<sup>121</sup> Interestingly Rappaport reported that some municipalities prefer to buy commercial rather than join municipal liability pools because the commercial insurers "tend to be less aggressive about loss prevention" and thus "leave them greater autonomy over their policing operations." See Rappaport, *supra* note 15, at 1566. In the LPL context, mutuals promote this kind of autonomy to the extent that they grant the law firms greater control of the defense of claims than the commercials.

<sup>122</sup> LPL Ins. Interviews, Interview with Respondent #26, *supra* note 16, at 6.



this focus on the demand side of the governance aspects of the insurance relationship.<sup>123</sup>

Among all of our respondents who are involved in the LPL mutuals, and even some who are not, there was remarkable uniformity about the benefits we just described: stability in LPL insurance relationships; a high-quality claims experience; a commitment to loss prevention; and the professional development that comes from being part of a larger group of quality law firms.<sup>124</sup> All of these reasons connect to professional independence.

Stable insurance relationships free law firms from the worry that a commercial insurer will decide to leave the LPL market or make other dramatic changes that would interfere with the firm's ability to obtain reliable LPL insurance. Scrambling to fill a gap in an insurance program in a hard market interferes with professional independence by taking time away from the partner(s) involved in that effort and distracting other lawyers in the firm. Avoiding that distraction is part of the appeal of belonging to a mutual.<sup>125</sup>

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<sup>123</sup> See Swedloff & Baker, *supra* note 6.

<sup>124</sup> See *A Legal Mindset Permeates ALAS*, *supra* note 31 (describing the benefits of ALAS as: "stable rates, good claims service, proactive loss prevention, and pride in participating with other prestigious firms"). See, e.g., the quotes from LPL Ins. Interviews, Interview with Respondent #23, *supra* note 42; LPL Ins. Interviews, Interview with Respondent #24, *supra* note 68; LPL Ins. Interviews, Interview with Respondent #26, *supra* note 16; LPL Ins. Interviews, Interview with Respondent #28, *supra* note 102; LPL Ins. Interviews, Interview with Respondent #32, *supra* note 35; LPL Ins. Interviews, Interview with Respondent #34, *supra* note 47. See also LPL Ins. Interviews, Interview with Respondent #35, *supra* note 93, at 5 ("there is some preservation of control of the claim process).

<sup>125</sup> As one respondent explained:

You could save money in most years anyway you could probably get insurance cheaper elsewhere. The combination of claims and loss prevention service, the stability, the commitment to the market are all very attractive and substantial features of that. I mean there are plenty of terrific commercial insurers out there, sometimes they have varying degrees to which they are committed to the professional liability market or at least at a certain capacity and so forth.

Trust that there will be a high-quality claims experience frees law firms from the worry that their insurer will disappear when a large claim arrives. Moreover, because the “claims are administered by lawyers from other firms that you know” or in the case of ALAS former partners in member law firms, the claims experience bears more in common with peer review than most general counsels’ understanding of the commercial insurance claims process. A senior lawyer with experience in firms that were members of two different mutuals made this point as follows:

The reason that [firm A] and [firm B] and the firms in [mutual] are in mutuals, in my opinion, would be, one, dealing at arm’s length with the commercial insurer is different than dealing with an organization that you have a stake in and probably have a general counsel seated at the board of directors in the company or doing something within the company. You’re just treated differently. It’s not an arm’s length transaction where, when you report the claim, you get a 40-page reservation of rights letter and they start looking at ways to get out of coverage. We don’t—I’ve always felt the proper approach to a legal malpractice claim for a carrier is you look for coverage. Somebody’s paid a premium. They bought insurance for this. If there is potential for coverage or reasonable interpretation that provides potential for coverage it’s covered until it’s not. I mean commercial insurers, this is my bias, they approach it entirely differently. They get a claim in and the first resistance, how can we avoid covering this.<sup>126</sup>

The general counsels’ discussion of loss prevention similarly emphasized the quality of the service and the fact that it came from peers, not from a “big outside insurance company ... coming to us and saying, ‘Run yourself this way.’”<sup>127</sup>

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The thing you don’t want is to be hooked up in a substantial way with an insurer that decides it doesn’t want to write this kind of insurance anymore or having nothing to do with your particular firm. There’s no risk of that with ALAS.

LPL Ins. Interviews, Interview with Respondent #30, *supra* note 70, at 10.

<sup>126</sup> LPL Ins. Interviews, Interview with Respondent #52, *supra* note 79, at 6.

<sup>127</sup> LPL Ins. Interviews, Interview with Respondent #26, *supra* note 16, at 6, 12.

Finally, although few of our general counsel respondents spoke explicitly about the professional development aspects of participation in the mutuals, it was clear that most of them regarded the lawyers from other firms who participated in their groups as potentially valuable peers and that they valued their participation in the group experience for reasons that went beyond just risk transfer, loss prevention, and good claims handling. As the general counsel from one ALAS firm described:

ALAS only does legal malpractice for a certain kind of practice, a corporate practice, not a money-center practice, a practice of good quality firms in cities like Philadelphia, Cincinnati, but not cities like New York, Chicago,<sup>128</sup> L.A., San Francisco, although that's changing. .... Their expertise is right for what we do. ... [It's notable there is] a very high percentage of the firms who are members, who are represented at the annual meeting. ... They're all like you are. .... People who work at ALAS in both claims and loss prevention are also people from our background, people who came out of corporate law firms.<sup>129</sup>

## V. ASSESSING THE CONTRARY REPORTS

To this point we have reported what our respondents who are involved in the LPL mutuals have told us about the benefits of that involvement. Perhaps not surprisingly, respondents who work in the commercial market report that the differences between buying purely commercial and participating in the mutuals are less than the members of the mutuals report. In this part we examine and find significant justification for their skepticism. We find this skepticism credible for three reasons. First, as most participants in the purely commercial market report, the commercial market has developed its own mechanisms to deal with the problems of long-term contracting, adverse selection, and moral hazard. Second, there are no purely mutual insurance relationships. All of the mutuals have a significant commercial component. Third, the large market share of the mutual insurers, and their demonstrated ability to expand when needed, forces the commercial insurers to act more like mutual insurers in at least certain respects.

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<sup>128</sup> Note that ALAS has long had many member firms in Chicago, but not from New York, Los Angeles or San Francisco.

<sup>129</sup> LPL Ins. Interviews, Interview with Respondent #27, *supra* note 113, at 1-2.

A. ADDRESSING MARKET FAILURES IN THE COMMERCIAL MARKET

Members of the commercial market report that they provide similar benefits to their mutual peers in the form of stability in insurance relationships, commitment to the LPL market, and access to those loss prevention services they deem necessary.

**Stability.** Commercial brokers report that long term relationships with insurers are not unique to law firm mutuals. Commercial brokers work to provide the same long-term relationships and stability for their purely commercial customers that mutuals provide to their members. As one broker stated: “The bottom line is we like keeping the same carriers on a firm’s program for a long period of time, so long as the pricing is right, because there’s stability there that’s good for everybody.”<sup>130</sup>

Moreover, a long-term relationship with a broker might provide similar stability to large law firms as membership in a mutual, perhaps even at a lower cost, especially when that cost is understood to include the time that lawyers in the firm devote to the mutual. For law firms that buy strictly commercial there are no boards or committees, no member surplus accounts, and certainly no unitary or quasi-unitary pricing. One law firm general counsel put it to us this way:

I was always perfectly content to leave the insurance to the insurance people and to leave the law to the law people, and I always felt that—I mean, Minet was looking out after our interests, and later Minet was purchased by Aon, so now it’s Aon. We’re still customers of Aon. We’ve been basically represented by the same entity since 1976 when Minet first got us as a client. I just don’t see the point of spending a lot of time and energy. I’m glad that ALAS exists because the insurance market is very oligarchic, and there’s really just Aon and Marsh, and there really isn’t anybody else. I think it’s healthy to have more competitors in that market ... Joining ALAS meant a kind of commitment of time and energy that I think a lot of people just didn’t feel like making.<sup>131</sup>

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<sup>130</sup> Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #8, at 15 (Sept. 25, 2013) (unpublished interviews, on file with authors) [hereinafter LPL Ins. Interviews, Interview with Respondent #8].

<sup>131</sup> LPL Ins. Interviews, Interview with Respondent #21, *supra* note 90, at 5.

Whether the brokers would be able to provide this same comfort in a market without ALAS, MPC, BAR, AIM or PilotLegis is, for us, the key question. The presence of these options clearly gives brokers negotiating leverage when going out into the commercial market to obtain coverage for the law firms that they represent. The difference that leverage makes in the pricing and other terms of the coverage, however, is not a question that this form of research can definitely answer.

Further adding to the credibility of the stability claim is the expectation in the commercial market – even if sometimes honored in the breach – that for law firms above a certain size, LPL insurance should primarily function to spread risk across time, and not in the long run across law firms. That is possible only with long-term relationships. In contrast to other commercial insurance arrangement with which we are familiar from research and practice, there appears to be greater agreement among buyers and sellers about the importance of long-term relationships and about the principle that a good long-term relationship means that primary insurers will make a reasonable profit at the individual law firm level, at least for large firms.<sup>132</sup> The concept that our respondents used to explain how this principle works in practice is “payback,” which refers to paying above market premiums after a loss, so that, “In the long run your premiums are 120 percent of your claims.”<sup>133</sup> Significantly, commercial insurance underwriters report that they enforce this principle by refraining from undercutting the premium of an insurer receiving payback.<sup>134</sup>

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<sup>132</sup> Note that this expectation does not mean or require that individual *excess* insurers will have a good underwriting ratio at the individual firm level. The number of very large claims is simply too small for that to occur. The most that a high level excess insurer can expect is to earn a reasonable profit on its entire book over time.

<sup>133</sup> A CFO put it this way: “[Legendary broker] was very good on this. He would always say, ‘In the long run your premiums are 120 percent of your claims.’” Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #50, at 11 (June 11, 2013) (unpublished interviews, on file with authors). An actuary put it this way: “This ties back into the size of the account. If it was a truly large firm, I might expect it to be profitable on its own.” Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #39, at 6 (Nov. 1, 2013) (unpublished interviews, on file with authors).

<sup>134</sup> A senior executive at a commercial insurer explained this to us as follows:

Part of what makes this claim credible is that the commercial LPL insurance market is significantly smaller than the D&O insurance market, which, as prior research reports, is able to enforce norms that require collective effort to maintain.<sup>135</sup> There are fewer than ten commercial insurers

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Now, I'm also not going to come in and just bid against a firm that needs to get what we call payback. If you're on the losing end on a firm and they need to start to payback because you've lost money on them, I think most responsible markets would turn and say, "Yeah, that's part of the deal." You can't hit somebody up with a big loss and then say, "I want a rate reduction cuz we're gonna change things." Even if you're changing things, there has to be some consistency. There has to be some loyalty to the market cuz, otherwise, I know that when I get banged around, my guys are just gonna walk away, so I'm not there to just do that.

LPL Ins. Interviews, Interview with Respondent #18, *supra* note 72, at 8-9. Another respondent put it this way:

Q: Can I just ask a follow up question about that? When you were saying that the large firms aren't a traditional insurance transaction—in other words, for them, they're big enough that it's more that they're managing their cash flow than that they're actually—

R: Yeah, I think that's a good description. It was more kind of a—oh, what's it called. You know you'd price it at year-end and look back and say, "Losses exceed what we—the expected loss or not," and it was kind of a, "Let's split the difference with your carrier." As opposed to a premium up front, it was more of a retro price contract.

Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #11, at 5 (Nov. 16, 2013) (unpublished interviews, on file with authors).

<sup>135</sup> See generally TOM BAKER & SEAN GRIFFITH, ENSURING CORPORATE MISCONDUCT: HOW LIABILITY INSURANCE UNDERMINES SHAREHOLDER LITIGATION (Univ. of Chicago Press, 2010) (noting that D&O insurers can reintroduce the deterrence function of shareholder

at any time that are willing and able to take a “lead” position in a large law firm LPL insurance program.<sup>136</sup> One insurance broker – Aon – services a large percentage of the large law firm LPL market, putting it in a good position to enforce this norm.<sup>137</sup> A law firm that needs \$100 million or more coverage from insurers that will not provide more than \$10 million each cannot afford to alienate very many insurers.<sup>138</sup> And the people responsible for purchasing insurance in large law firms are partners in those firms (typically litigation partners), with the intelligence and the paranoia needed to appreciate how changing insurers exposes their law firms to continuity risk. Taken together, all these factors provide support for the existence and force of the payback norm and, thus, the brokers’ and commercial underwriters’ assertion that large law firms don’t have to belong to a mutual to have stable insurance relationships, at least as long as the presence of the mutuals provides a credible alternative for a significant share of the law firms buying purely commercial.

At the same time, the flexibility of commercial pricing provides an opening for the commercial market to try to recruit lower risk firms to leave the mutual. As brokers and commercial underwriters emphasize, the unitary and quasi-unitary pricing of the mutual insurers works to the advantage of members with poor claims histories and to the disadvantage of the “squeaky clean” firms:

There is a figure, which is a per-lawyer charge. The big problem there is: that’s great if you’re not a very good law firm. If you have lots of losses, that’s great, isn’t it? Basically, the good guys are subsidizing you. Conversely, if you’re an extremely professionally run and you’re as clean as a whistle, you’re helping to pay the losses of other firms for which you receive nothing. There are arguments, and ALAS will make them quite strongly, where they’ll say,

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litigation through pricing, insurance monitoring and loss-prevention programs, controls over defense settlements, and coverage defenses).

<sup>136</sup> See E-mail from Respondent #18 (Jun. 15, 2016) (on file with authors).

<sup>137</sup> DOUGLAS R. RICHMOND ET AL., AON RISK SOLUTIONS, QUALITY ASSURANCE REVIEW: A TIMELY REVIEW OF PRACTICE MANAGEMENT ISSUES AFFECTING THE LEGAL PROFESSION (2015) (noting that Aon had served approximately 275 firms over the past 10 years).

<sup>138</sup> See Baker & Swedloff, *supra* note 45, at 1282 nn.24-25 and accompanying text.

“There’s no such thing as an entirely clean law firm. Therefore, the mutuality is more important, this idea of being a strong group. It gives us purchasing power. It allows us to remain stable through all markets.” The truth of the matter is, mutuals are better for bad insureds. If you’re clean as a whistle, you’re better off out there in the market.<sup>139</sup>

Of course, as this last statement reflects, the advocates of the purely commercial approach are trying to have their cake and eat it, too, reporting that they are able to provide the stability and loss prevention benefits of the mutuals, but at the lower cost that reflects the risk of the “squeaky clean” members of the mutual organizations.<sup>140</sup> That may be the case for those squeaky-clean members, and as long as there is no liability insurance crisis. Law firms with more difficult claims histories, however, will not receive that preferred pricing. Moreover, LPL insurance policies get re-priced every year, renewal is not guaranteed, and the premium increases and market share shake-up during the early 2000 hard market suggest that there remains a risk that commercial insurers could leave the market.<sup>141</sup>

Of course, commercial brokers downplay this risk, asserting that there is little reason to fear that commercial insurers will abandon the LPL market and that customers are not really worried about that eventuality. Noting that 30 years have passed since the mid-1980s liability insurance crisis, one broker reported that law firms’ concerns about commercial insurers lack of long-term commitment to the LPL market “has dissipated”:

Most of those people who were involved in that [crisis] don’t even believe there’s a possibility that they could be left without insurance, so the continuance of the relationship of insurance slides down the agenda, I think, from the managing partner to other partners. It is no longer one of the vital relationships that the managing partner thinks he has to preserve, as he becomes managing partner, because it’s

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<sup>139</sup> Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #48, at 7 (Nov. 6, 2013) (unpublished interviews, on file with authors).

<sup>140</sup> See LPL Ins. Interviews, Interview with Respondent #18, *supra* note 72 (reporting that “squeaky clean” firms can save 30-35% by leaving ALAS and buying purely commercial).

<sup>141</sup> David Hechler, *Malpractice Policies Going Up; A 10-Year Buyers’ Market Has Ended*, NAT’L L. J., June 3, 2002, at A1.



been a stable relationship, ever since. ... I think, the likelihood that that complete disappearance will occur again is extremely remote. Anyway, it hasn't happened. These guys were in high school, when that happened.<sup>142</sup>

Although it is obviously the case that the market has performed adequately for a long time and, thus, the strength of the underwriting cycle explanation for the continuing need for LPL mutual insurance has waned, count us as among those skeptical that the liability insurance industry has sufficiently tamed the underwriting cycle to eliminate the need for LPL mutual insurance organizations.

**Loss Prevention Services.** Mutual members report that they value loss prevention services and those services could help mitigate moral hazard. We find evidence that commercial insurers have hedged their bets on this front. On the one hand, some of our commercial insurance respondents question whether the greater attention to loss prevention by the mutuals makes any difference at this point, given that most firms have adopted significant risk management structures through centralization:

To be frank with you, I think there are clearly the nuts and bolts of risk management that all firms have to have done and do properly. They have to have conflicts of interest systems in place. They've got to have good diary and calendar systems. They have to have some type of peer review where they're watching what their partners do. They have to have somebody look over tax opinion letters. They need to have some sort of system in place to make certain that their partners don't have substance abuse problems and that the checks are being countersigned. When you get to a firm of a certain size, they have all that down. They know what they're doing. I always find it interesting that the outfit that has the greatest loss prevention and risk management out there, that people just tout constantly, is ALAS. That's what they're known for in the industry is how good their risk management and loss prevention is. Interestingly, their loss

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<sup>142</sup> Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #7, at 16 (May 29, 2013) (unpublished interviews, on file with authors).

history is no different or no better than, no worse, than the commercial market.<sup>143</sup>

On the other, commercial insurers can and do fill this gap by partnering with other providers in the market to provide loss prevention services. For example, the large LPL broker, Aon, has its own loss prevention experts, who, like the ALAS loss prevention experts, are also former partners in law firms.<sup>144</sup> Through these experts, Aon puts on programming about setting up and maintaining loss prevention structures and cultures in law firms.<sup>145</sup> For law firms working with other brokers, there are independent loss prevention experts, and commercial insurance companies sometimes provide credits that help law firms offset the price of hiring those experts.<sup>146</sup>

#### B. HYBRIDS

Another part of what makes the commercial brokers' skepticism credible is the fact that, especially in terms of risk distribution, the differences between buying purely commercial LPL insurance and participating in a mutual are less stark than reading either the insurance literature or the law and economics literature might suggest. The reason is that there are no purely mutual LPL insurance arrangements. All of the LPL mutuals – especially ALAS – purchase significant reinsurance, and their reinsurers are part of the same insurance capital market as the commercial insurers. Moreover, apart from ALAS, all of the mutuals purchase commercial excess insurance for their members, and the largest ALAS members do so on their own.

This means that all of these mutual insurance arrangements have significant commercial insurance aspects. At one end of the continuum there is PLUG: a short-term, broker-driven mutual component in an otherwise purely commercial LPL program. At the other end is ALAS: a large LPL mutual with a sizeable staff that uses the reinsurance capacity of the

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<sup>143</sup> LPL Ins. Interviews, Interview with Respondent #18, *supra* note 72, at 18-19.

<sup>144</sup> The head of Aon's loss prevention group is a former partner in an ALAS member firm.

<sup>145</sup> LPL Ins. Interviews, Interview with Respondent #8, *supra* note 130, at 2.

<sup>146</sup> Tom Baker & Rick Swedloff, LPL Ins. Interviews, Interview with Respondent #43, at 16 (Dec. 20, 2013) (unpublished interviews, on file with authors).

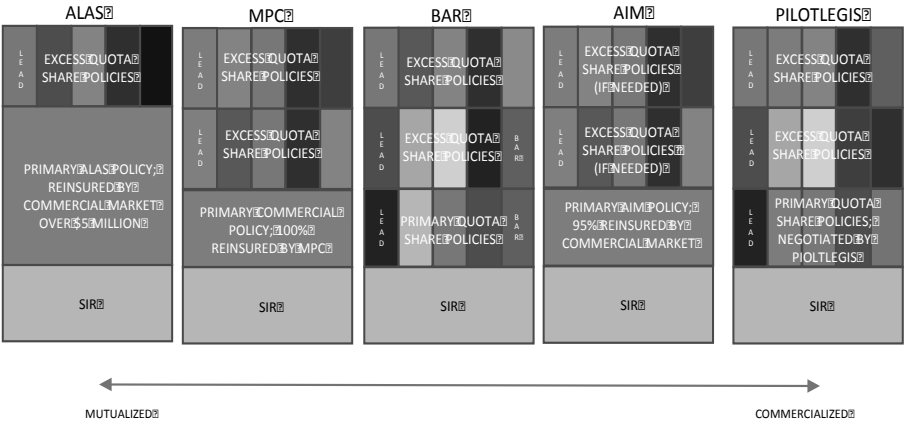
commercial insurance market and whose larger members buy high-level excess insurance on the commercial market on their own, without assistance from ALAS. The other mutual insurers occupy intermediate positions on this continuum:

- PilotLegis is a risk purchasing group, so all of its members are entirely insured by the commercial insurance that PilotLegis and Aon arrange for them. Nevertheless, because PilotLegis has committees, audits, and an expectation of permanence, the LPL arrangements of PilotLegis members are more mutual in nature than those of the firms in PLUG. While PilotLegis doesn't presently assume risk, it claims to be ready to do so.
- AIM differs from PilotLegis in being less broker-driven and, of course, it already bears risk, so AIM is a step further along the mutual continuum. Nevertheless, at least in terms of risk transfer, it functions primarily as a buying service for commercial insurance.
- BAR takes on much greater risk than AIM, but it relies on commercial insurers to take the lead in underwriting and pricing. In addition, BAR members obtain all of their higher-level excess insurance from the commercial market.
- MPC has a more arms-length relation with its brokers than BAR or AIM, and its members have a more active involvement in pricing than BAR, but MPC's substantial layer of primary "insurance" is actually reinsurance that backs a primary insurance policy provided by a commercial insurance company. While that commercial insurer hopes never to have to pay its own money, it would have to do so if MPC were to become insolvent. Like BAR, MPC functions as a buying service for higher-level commercial excess insurance.

Figure 1 shows the spectrum visually for the five currently operating mutual LPL insurance arrangements, using a stylized image that is not drawn to scale. Each of these arrangements involves commercial insurers. In terms of risk distribution, ALAS is the most mutualized of the insurers. As a formal matter, its members retain the risk of the first \$75 million for each policy ALAS writes. Even ALAS members, however, have a relationship with the commercial market because ALAS purchases reinsurance for losses above \$5 million, and members that want limits above \$75 million purchase excess insurance on the commercial market. PilotLegis is on the other end of the

spectrum, using the size and characteristics of their membership as a bargaining chip in negotiating primary insurance pricing.

Figure 1: The Relationship Between Mutual and Commercial Insurers



What all this means is that, at least in the LPL market, mutual and commercial insurance are complements. Except for those ALAS member firms, if any, that buy limits of \$5 million or less, the members of all of these mutual insurers are shifting a substantial share of their LPL risks into the commercial liability insurance market. And even an ALAS member that bought such a low level of coverage would depend on the participation of larger firms in ALAS. Those larger firms would be quite unlikely to remain in ALAS if there were there no higher, reinsurance-facilitated levels of coverage. Thus, for firms with the option to join a lawyers’ mutual insurance organization, the choice is not between mutual and commercial insurance, but rather between a mutual/commercial hybrid and commercial insurance.

Indeed, as a result of this research we think about mutual LPL insurance as not simply an alternative to the commercial insurance market, but rather as a mechanism for managing law firms’ access to that market. The mutuals facilitate a risk management and transfer approach in which (1) the partners of individual firms share the lowest, most likely to be accessed layer of exposure through the firms’ self-insured retentions, (2) the member firms share the next exposure layer through the insurance issued by the mutual that is not reinsured, and, (3) beyond that, the firms shift their risks to the commercial (re)insurance market.

Accordingly, we agree with the advocates of the purely commercial approach that the differences between buying commercial and joining a

mutual are not as stark as the mutual advocates (and the usual academic literature) suggest, especially when it comes to risk distribution. The hybrid nature of the mutual insurance arrangements clearly reduces the risk distribution differences as compared to a hypothetical, purely mutualized arrangement.

On the other hand, the mutual LPL advocates are also right. Competition has not eliminated the differences between them. The mutuals offer member-directed operating committees, member control over claims settlement at lower levels, a strong member voice in settlements at higher levels, and a sense of participating in a common enterprise. The commercials do not. Moreover, the mutuals can commit, to a degree that no commercial insurer ever can, that they will never leave the LPL market. These are real differences. Lastly, because the mutuals can access the commercial market directly or through reinsurance, they are not as capital constrained as the theoretical literature's focus on purely mutualized arrangements would suggest. The LPL mutuals can thus diversify their risks to a significant degree and, thus, are not particularly vulnerable to competition on that basis from the purely commercial market.

## VI. CONCLUSION

Our respondents reported a variety of benefits to belonging to a mutual insurer: stability in LPL insurance relationships, a high-quality claims experience, high quality loss prevention services, stable pricing, and, for some of them, participation with like-minded law firms that provide opportunities for professional development. These reports match reasonably well with economic theory. Stability in relationships and stable pricing are the desired result of addressing the long-term contracting problem. The perception that key aspects of the relationship are high quality can be understood as both cause and effect of the mutuals' comparative advantage in addressing that contracting problem. The sense of solidarity and professional development can be understood as both cause and effect of mutual insurers' comparative advantage in addressing adverse selection. Loss prevention and claims handling both implicate moral hazard – ex ante moral hazard in the case of loss prevention and ex post moral hazard in the case of claims handling. Finally, the reports from the legal profession literature about the norms of professional autonomy and independence help explain why a law firm might prefer that a lawyer owned and operated mutual engage in the efforts required to manage moral hazard, adverse selection and the long term contracting problem.

Based on the fact that most lawyers in medium to large law firms are not part of an LPL mutual, however, it is obvious that the commercial insurers – stock companies and the London Market syndicates – have been able to adequately address the potential market failures that could result from moral hazard, adverse selection and the long-term contracting problem. It is of course possible that another liability insurance crisis that is as severe as that of the mid-1980s could drive the commercial insurers sufficiently out of the market to change that analysis. But, even in that event, history suggests that significant numbers of the law firms that prefer to buy commercial insurance will be able to “PLUG” the gap with the assistance of their insurance brokers, so that they will remain primarily in the commercial market.<sup>147</sup>

For us, the image that best captures this situation is that of law firms arrayed on a risk mutualization continuum. At one end are long-term members of ALAS whose perceived liability risks are small enough that they have been able to obtain all their insurance from ALAS. At the other end are law firms that have never participated in a mutual – not even PLUG. There is some movement of firms on that spectrum that is likely to be correlated with, but not entirely driven by, the liability insurance underwriting cycle. But, just as law firms differ along other dimensions that resist simple explanation, firms differ in the degree to which they find the mutuals appealing. Moreover, if the cream-skimming ability of the mutuals is real (we believe it is), then there always will be law firms unable to join them. At the same time, however, both the risk profile of the firms and the mutuals’ standards seem likely to change over time, providing further reason to expect movement along the continuum.

Importantly, every place on that continuum implicates both mutual and stock insurance arrangements. Even an ALAS member that bought all of its LPL insurance from ALAS would benefit from the risk distribution provided by ALAS’s commercial reinsurers. And even the law firms that have never mutualized their liability risks benefit from the market shaping practices of the LPL mutual insurers. As our research shows, mutual and commercial insurers are not just competitors, they are also complements. Indeed, it would be better to think of mutual insurance arrangements in the professional liability context, not as an alternative to stock insurance, but rather as a mechanism for managing firms’ access to the powerful risk distributing potential of stock insurance. Moreover, even this framing may overstate the separation between commercial and mutual insurance and

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<sup>147</sup> See *supra* Part III.D.

obscure the degree to which the availability of mutual insurance affects the behavior of the commercial insurance companies.

Accordingly, we conclude that the mutuals provide benefits even for the law firms that buy purely commercial. While qualitative research cannot prove that law firms' experience with the commercial market would be less satisfactory in the absence of a strong mutual LPL sector, our judgment is that a significant decline of the mutual sector would lead to a decline in the quality of the insurance relationships in the commercial LPL sector.<sup>148</sup> The presence of the mutual insurance option – not just the existing insurers but also the knowledge that Aon or Marsh or a well-connected specialty broker could help another group of law firms create a new PLUG or AIM or PilotLegis<sup>149</sup> – cannot help but act as a check on commercial insurers, even in their dealings with law firms that exclusively buy commercial insurance.

Thus, our research supports efforts to promote LPL mutual insurance arrangements. It also provides a basis for the law firms that belong to the LPL mutuals to view their lawyers' participation not only as a service to the mutual and the firm but also as service to the legal profession.

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<sup>148</sup> This is, admittedly, an impression formed on the basis of less than complete information. It is not a judgment that is subject to proof, at least in the absence of a decline in the mutual sector, and, even then, there likely would be too many confounding factors to allow proof of causation. Moreover, as long as there remains the perception among a significant share of the bar that law firm mutuals promote professional autonomy, that judgment will never be put to proof.

<sup>149</sup> Creating a new MPC or BAR would be more difficult because of the amount of capital that those two insurers have accumulated. Creating a new ALAS would have that problem, plus the challenge of creating such a significant organizational structure.